

## Microfinance Market Outlook 2012

### Persistent Demand Provides for Stable Returns

#### Key Findings

- After a year of rapid expansion, microfinance loan portfolio growth is likely to moderate in 2012. Industry experts predict a real growth rate of 15-20%.
- The strongest growth is forecast for South and East Asia, unless consolidation in India stalls.
- Nonperforming loans are projected to remain on the current low levels. Regional differences might decrease due to mean reversion.
- Profitability has reached pre-crisis highs, but is set to moderate to its long term average in 2012.
- As repayment rates have fully recovered and local demand persists, microfinance institutions express an increased appetite for funding.
- After substantially increasing investment capacity in 2011 we expect to grow at market pace in 2012 with funds being fully invested.

This Market Outlook is based on a comprehensive survey of 27 industry experts representing all major microfinance markets, as well as on responsAbility's extensive market data. The experts surveyed represent microfinance institutions (MFIs), investors, rating agencies, and consultants.

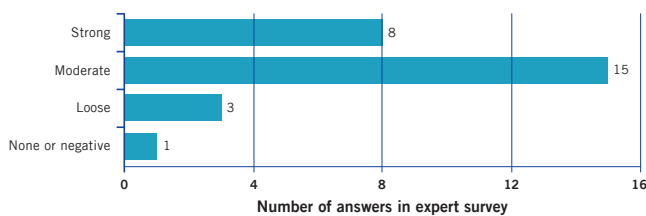
### Moderation Is Welcome

A year ago, all experts surveyed for the Microfinance Market Outlook 2011 predicted solid portfolio growth and increased demand for microfinance in their respective regions. Indeed, they correctly predicted the strongest growth in three years. Expansion occurred at somewhat slower rates than in the years prior to 2009, but was accompanied by greater risk management capacity and better corporate governance than in any other period in microfinance history. Portfolio quality has improved as the share of nonperforming loans decreased to precrisis levels, while profitability forcefully bounced back from the relative low in 2009. Renewed sustained growth even in traditional microfinance markets demonstrates that the potential for microfinance remains vast as hundreds of millions of households still lack access to reliable finance.

### Macro Matters

The macroeconomic environment in emerging markets was very favorable in 2011, adding a second year of strong recovery in those countries that had been affected by the world economic crisis. Parallel to this macroeconomic recovery, microfinance was thriving. Indeed, the experts surveyed for this outlook increasingly view microfinance as correlated with the business cycle of the overall economy in their regions. A moderate correlation is observed by 56% of the experts, while 30% see a strong correlation. In accordance with this dominating view, we give a closer macroeconomic outlook on the markets relevant for microfinance investors.

Correlation with Overall Economy in the Region



### The Two-Speed Recovery Continues

#### The Old World

As 2011 ends, the prospects for the world economy have darkened. The former economic superpowers, the G-7, are bound by problems of their own making. Uncertainty and fear dominate the investment universe. The future of the Eurozone is unclear. In 2012, it will remain at the epicenter of global economic risk.

The advanced economies are in a sorry state. Medical terms being appropriate, the growth outlook can be described as anemic in the short run and sclerotic in the longer term. In 2012, Europe is expected to stagnate at best, while the US recovery remains elusive. Contagion effects are expected to curb business investment and consumer spending in the US next year. Moreover, a huge pile of debt and stubbornly high unemployment rates are likely to continue to mire the developed world for years to come.

“Following the light of the sun, we left the Old World.”

Christopher Columbus

#### The New World

In the past, stability used to come from the West, while developing economies appeared to indulge in homemade chaos. Evidently, the roles have reversed dramatically. Today, the world economy grows because emerging markets advance relentlessly. Their strong fundamentals are explained by four significant factors:

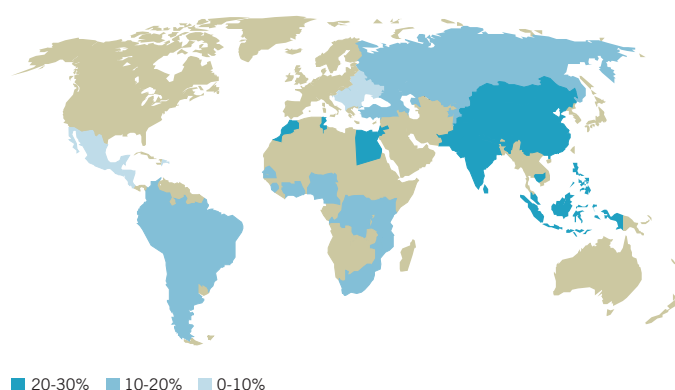
1. More fiscal discipline and a more independent monetary policy have brought inflation under control in most countries. Central bank and monetary framework reforms led to the strengthening of reserve banks vis-à-vis governments. As a result, central banks' financial positions have vastly improved, and exchange rates have become more flexible, reducing the vulnerability to external shocks.
2. Thanks to thriving export sectors, developing economies have accumulated current account surpluses and attracted more direct and capital investments, which reduced their dependence on foreign financing. Developing economies and emerging markets will have accumulated more than USD 7 trillion in foreign currency reserves by the end of 2011, more than twice as much as the advanced economies.

3. While extractive commodity exports like crude oil, ores, and metals boost the economies of numerous emerging markets, export revenue growth has also been achieved with agricultural goods such as coffee or cotton<sup>1</sup>, both widely harvested in non-oil-producing countries. However, net commodity-importing development countries have also grown at a rapid pace. Indeed, robust wage growth has occurred in all developing economies, in stark contrast with stagnating wages in the advanced economies. Rising wages led to a significant increase in domestic consumption in developing economies, shielding them against swings in international trade. Moreover, wage growth has led to higher tax revenues, which should produce better financed and more accountable public institutions.
4. Most interestingly for investors in microfinance, the development of financial sectors shows concrete results on a macro level. The deepening of financial intermediation is a key factor of stability. Well-functioning financial systems promote growth and expand economic opportunities. One powerful indication for the advancements in building financial sectors in developing economies has been the retreat of dollarization.<sup>2</sup>

#### Regional Overview and Microfinance Growth Forecasts

By the end of 2011, economic growth has moderated in emerging markets. Export growth to Europe and the US is falling. Overall, moderation is welcome, as signs of overheating were a major concern during 2011. Relevant for microfinance is whether the crisis in the West will affect domestic demand. Several experts note that the very fact that microfinance is rooted in the informal sector mitigates external shocks. Others note that microfinance does have external exposure: the remittances. Regions with a large share of the population working in Europe and the US, namely Eastern Europe and Central America, are expected to continue to see the growth of their microfinance industries impaired. Additionally, scarce funding due to the European banking crisis may particularly affect microfinance in Eastern Europe. In short, exposure to sagging Western economies is the major drawback on microfinance growth for 2012.

**Microfinance Growth Outlook per Region**  
(Gross loan portfolio year-on-year growth in real terms)



Region	Outlook 2012
Central America	5–10%
South America	10–20%
Eastern Europe	0–10%
Middle East and North Africa	15–25%
Sub-Saharan Africa	10–20%
Caucasus	10–20%
Central Asia	15–20%
South and East Asia	20–30%
<b>Total</b>	<b>15–20%</b>

Anti-inflationary policies and restrained export demand are showing their effects in South and East Asia. In case of a prolonged slowdown in 2012, a reassuring repertoire of fiscal and monetary stimuli is at hand. Microfinance is expected to continue on its growth path. An important difference to last year is reduced uncertainty in India (see separate box on page 4).

<sup>1</sup> The price of cotton grew threefold from 2009 to 2011, while coffee prices more than doubled in the same period (Unctad 2011);

<sup>2</sup> For instance, dollarization in Bolivia decreased from over 90% of both credit and deposits in the year 2000 to 50% in 2010. Peru's dollarization rate fell from 80% to 50% over the same period. Similar figures were observed in Asian economies.

In South America, sound macroeconomic policies continue to yield growth dividends. Domestic consumption is strong. If commodity prices remain at their current comfortable levels, South America will continue to grow much faster than Central America. The latter is hindered by exposure to the lethargic US economy. Microfinance is expected to continue to expand strongly, led by sustained market growth in Colombia, Ecuador, and Peru. The smaller markets of Paraguay and Argentina are considered to be on a far less sustainable growth path. A correction in their banking sectors would have implications for microfinance. Central American microfinance has finally emerged from its 2009/2010 crisis, but will be held back by lower remittances from the US.

Convergence has become a foul word in Eastern Europe. The region might see subdued growth due to its exposure to the Eurozone.<sup>3</sup> Experts expect a leveling out at modest growth levels, as hitherto-fast-growing Turkey slows down, while countries closer to Russia can step up their growth rates. This also holds for the Caucasus and Central Asia. Microfinance might still see modest growth in Eastern Europe as European commercial banks are forced to pull back from the region to shrink their balance sheets. Microfinance expands faster in the Caucasus and Central Asia, but is tainted by local problems of overindebtedness.

Economic growth in Africa appears robust. On the one hand, a rebound is expected in the MENA region following the Arab Spring. On the other hand, sub-Saharan Africa is likely to continue to benefit from high commodity prices, increasing external inflows, and growing domestic demand. Microfinance will benefit from donor-money inflows in the Arab Spring countries in 2012, but midterm effects remain unclear. Regarding sub-Saharan Africa, the experts surveyed hold more positive prospects than a year ago.

### **India 2012: Adapting to the New Rules**

In last year's Microfinance Market Outlook, we warned of downside risks in India, specifically for MFIs with operations in the state of Andhra Pradesh (AP). Those risks materialized shortly thereafter. Political adventurism by the local state government all but wiped out microfinance operations in AP and led to an identity crisis of the sector in India. This was the catalyst for a new all-India microfinance draft bill by the Indian central bank (RBI). The proposed bill is flawed, a proverbial Indian compromise, but can still act as the foundation for renewed growth in the microfinance industry. Even if the legislation certainly falls short of financial regulation benchmarks set by some Latin American countries, it is essential to reduce uncertainty and thus restore confidence among Indian banks and foreign investors. An open question is how quickly the bill will be passed in parliament. The processing is likely to be tainted by political power games between local, national, and party interests.

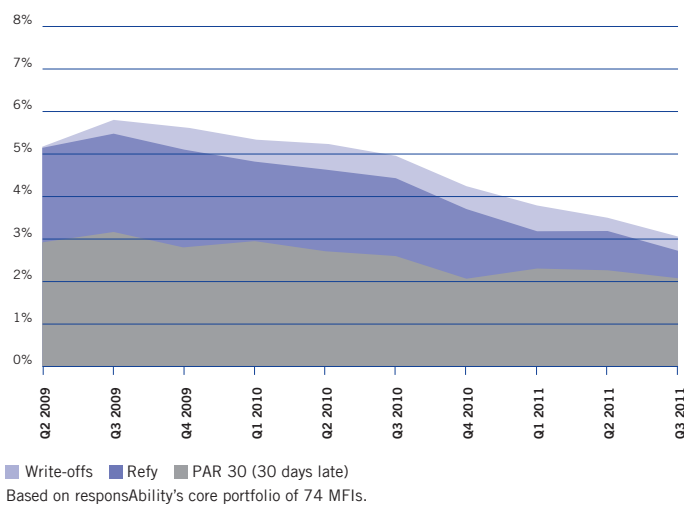
For India outside Andhra Pradesh (AP accounts for 7% of the Indian population), we expect new growth, but at lower rates than before the 2010/2011 crisis. Rigid rules (e.g., the interest rate cap) that favor large, urban MFIs and disfavor smaller operations in rural areas (those parts of India that need access to finance most) could drive a wave of consolidation in the sector. As a reaction to the rigidities, experts expect a number of institutions to diversify from microfinance and to adopt new business models such as housing finance. Thus, as with any new set of rules, the Indian microfinance regulation creates winners and losers. We are confident that we will see our investees among the former and expect a market growth of up to 20% in real terms for 2012 (outside AP, as our AP exposure is virtually zero). Since we trust in the ability of Indian MFIs to adapt to demanding regulation, we stick to our long-term goal of building financial sectors that create access to finance even in difficult territories, such as rural India.

<sup>3</sup> Almost half of Eastern European exports have the Eurozone as their destination. This compares to Africa and the Middle East at 16%, Asia at 13%, and Latin America at 11% (BIS and IMF, 2011).

## Portfolio Quality

Portfolio quality has seen a second year of improvement in 2011. The share of nonperforming loans shrank from 5% to 3% globally. PAR 30 has stabilized at a lower level, and the share of refinanced loans has decreased substantially, from 2.3% at the end of 2010 to 0.6% one year later. The share of loans written off has halved over the same period. This indicates that the effects of the Great Recession on microfinance have been successfully absorbed.

### Development of Portfolio Quality



According to the experts, a year of further improvements cannot be expected. Two-thirds of experts said that portfolios will remain roughly the same in their regions. An improvement is expected by 19% and a worsening by 15% of experts. More than a third of experts explicitly stated that the managing of portfolio risks would be a major challenge for MFIs in 2012.

“The 2009/2010 contraction provoked a due rationalization in microfinance. The impressive growth we have seen in 2011 demonstrated the forward power of the renewed sector. We are confident that the sector will also emphatically show its improved resilience in a less benign 2012.”

Christian Speckhardt, Chief Investment Officer, responsAbility

## The Funding Needs of MFIs

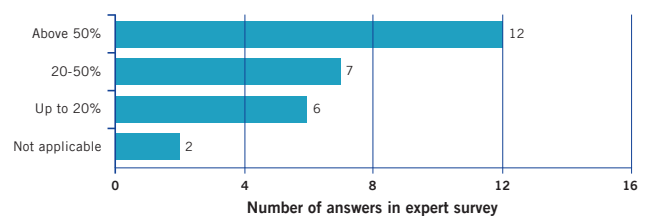
Funding is the lifeline of microfinance. If local MFIs cannot refinance themselves, they are barred from reaching out to micro-entrepreneurs and their households. Asked what kind of funding will become more important over the next three years, 70% of experts mentioned local funding sources and 50% international funding sources. Savings are the most favored funding source, mentioned by half of all experts. International equity follows suit with 37%. Almost a fifth of experts believe that international credit will play a still more important role in their regions in three years' time. Public money is generally not believed to gain importance, although a few experts conceded that public money will remain important in their markets, while others see it as naturally in decline as markets mature. The unwillingness of commercial banks to lend to MFIs is frequently deplored by experts, as is the absence of local private investors.

“Some commercial banks still hesitate to invest in MFIs due to a lack of confidence and an unwillingness to support potential future competitors.”

Senacheert Sim, President and CEO, PRASAC, Cambodia

Another salient funding need of MFIs is local currency debt. The more local financial markets develop and the more so-called exotic currencies gain stability – as compared to Western currencies – the stronger is the case for financing in local currencies. Asked what percentage of refinancing loans is given to MFIs in local currency, 12 out of 27 experts replied “more than half”. The other experts gave an estimate of a 20–50% or 0–20% share of the local currency. The question does not apply to countries without their own currency, such as dollarized Ecuador.

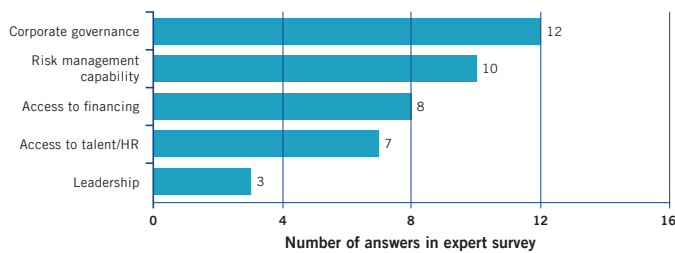
### Refinancing Loans in Local currency



### The Business Needs of MFIs

Asked about MFIs' business needs in 2012, the experts listed improving corporate governance first and increasing risk management capabilities second. The third-most-frequently-cited business need is improved access to finance. Fourth is access to talent. The latter is specifically sought after in Latin America, where more sophisticated microfinance markets require a large number of qualified professionals, an increasingly scarce resource for which MFIs directly compete with commercial banks.

#### Most Important Business Needs



### Consequences for Our Investors

- As the microfinance industry is expected to grow 15–20% in 2012, we foresee stable performance from our funds next year.
- Sector growth is expected to translate into stable financial performance at fund level, due to three key elements: unchanged risk profile; low liquidity levels; and stable valuations.
- Risk is expected to be controllable even better in 2012, as the professionalization of risk management inside countless MFIs and improved regulation in a number of markets are both counterweights to the inherent risk. This makes microfinance an attractive addition to any portfolio.

- Fund liquidity is expected to be at rather low levels, as our market positioning has strongly improved. We have opened and staffed local offices in Lima, Nairobi, and a local presence in Mumbai in order to be closer to the 258 MFIs we serve in 55 countries. As a consequence, our investment capacity has increased substantially, enabling us to cope with the sustained growth we expect in the years to come.
- As the valuation of microfinance funds is not derived from the interest rate environment, and pricing of equity positions is expected to be relatively stable, fund performance should match 2011 levels.
- For 2012, strong fundamentals suggest that microfinance will, once again, act as a bulwark against adverse general market forces. The interest rate environment is generally expected to remain unrewarding, while future increases will hurt bond and equity valuations without directly affecting microfinance.

“Microfinance investment vehicles are the most effective players whenever they have the patience to really accompany their clients.”

Fernando Fernández Araoz, Founding Director, DAI, Mexico

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