TRANSITIONS TO PRIVATE CAPITAL

CASE STUDIES FROM THE LIABILITY SIDE OF THE BALANCE SHEET

microREPORT #99

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CONTENTS

ACRONYMS

ACP	Acción Comunitaria del Perú Inversiones
BIO	Belgian Investment Company for Developing Countries
BCP	Banco de Crédito del Perú
CGAP	Consultative Group to Assist the Poor
CAF	Corporación Andina de Fomento
CD	certificates of deposit
COFIDE	Corporación Financiera de Desarrollo
EPYDME	Entities of Development for the Small and Micro Business
FONCODE	Fondo de Cooperacion para el Desarrollo Social - PERU
IADB	InterAmerican Development Bank
IFC	International Finance Corporation
MFI	microfinance institution
MTPE	Programa Perú Emprendedor del Ministerio de Trabajo y Promoción del Empleo
NGO	non-governmental organization
SBS	Superintendencia de Banca y Seguros
SOFOLE	Sociedad Financiera de Objeto Limitado
S&P	Standard & Poors

INTRODUCTION

This report presents three mini-case studies as a part of a three-year research effort examining financing of microfinance institutions (MFIs) and their transitions to private capital. The case studies are short histories focusing on the funding strategies and history of three MFIs: Compartamos in Mexico, and Mibanco and Entities of Development for the Small and Micro Business (EPYDME) EDYFICAR in Peru.[1]

The case studies also provided significant input and direction to a companion document, "MFI Financing Strategy Guidelines and Template," which is a guide to strategic funding planning and execution for smaller MFIs looking for growth and to access private capital.

While the case studies have the same objective of showing the evolution and strategic thinking behind funding and capital management, they are not identical in structure and content due to the nature of their different experience. Mibanco and Compartamos offer the most complex histories, involving savings, bonds, and other financing vehicles in explicit and long-established funding strategies. EDYFICAR, by contrast, is a larger MFI with significant funding needs but without access to savings, due to its institutional form and registration.

Together, these case studies represent a good cross-section of the funding situations in which MFIs may find themselves or may aspire to achieve. So while the case studies complement the MFI Financing Strategy Guidelines, each case study is also offered as a stand-alone document. It is our hope that they are illuminating and useful studies in financing strategy.

[1] This study builds off of work done previously under the Transition to Private Capital theme in Peru, Uganda, and the Philippines. Six institutions — two each from the three countries — agreed to participate in this study, but two dropped out due to the extensive data needs of the research.

SECTION ONE: MIBANCO: DIVERSITY, DEPOSITS, AND BONDS

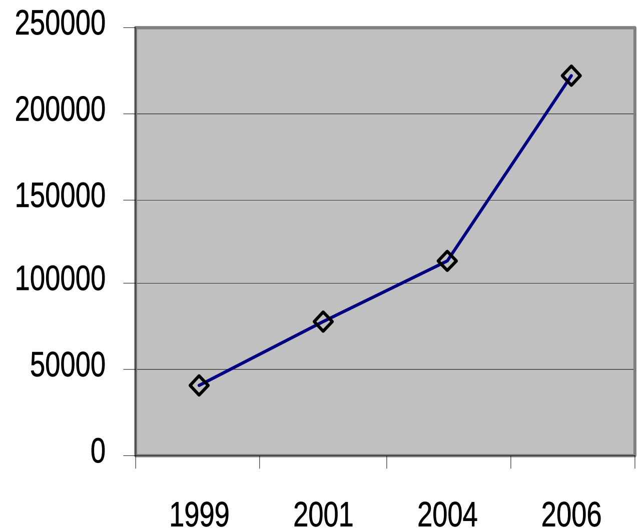
Originally formed in 1987 as a project of the non-governmental organization (NGO) Acción Comunitaria del Perú Inversiones (ACP), Mibanco has its roots in over 37 years of financial and non-financial services to microenterprises and small businesses. From 1982 until 1998, ACP focused on providing financial services to microenterprises through a lending program called Programa Progreso.

By the end of 1980s, ACP's Progreso had a loan portfolio of under $5 million with around 8000 clients. Growth through 1990s was healthy, aided in part by a series of structural changes in Peru that, among other improvements, liberalized the financial sector and put an end to usury laws and interest rate caps. By 1998, ACP had transformed into a regulated financial institution with almost 20,000 clients and a portfolio of more than $7 million.

FUNDING STRATEGY OPTIONS

Throughout the 1990s, ACP, as an NGO, had limited access to capital. Its primary sources were donations and loans from *Corporación Financiera de Desarrollo* (COFIDE), a government-owned second tier bank. Access limitations motivated ACP to explore the option in 1994 of becoming a regulated financial institution with deposit-taking capacity.

Figure 1: Mibanco Active Borrowers



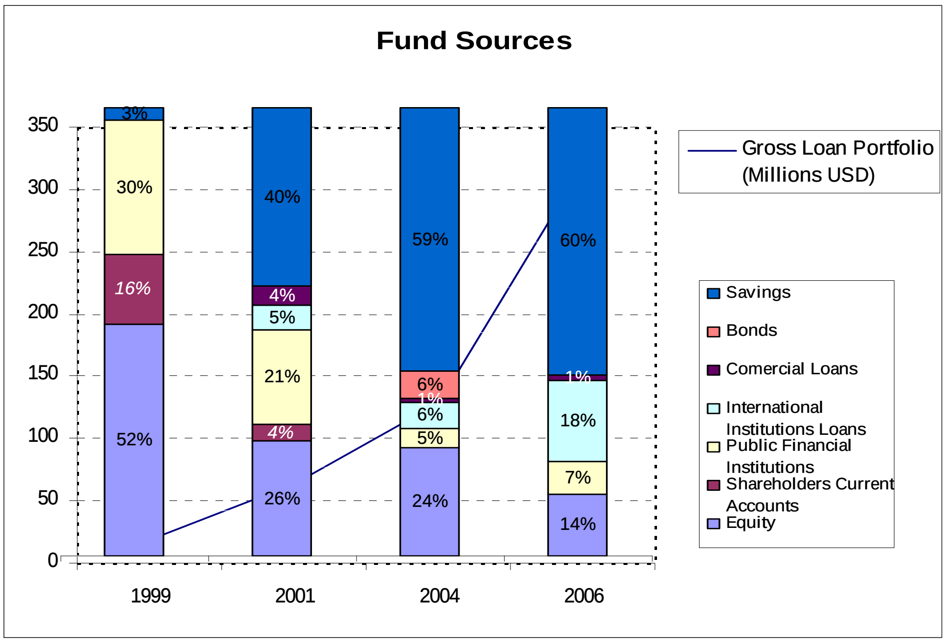
In 1994, ACP set it sights on becoming a finance company (*financiera*) with the right to collect term deposits. This form had a relatively modest capital requirement of USD $3 million, compared to the much larger base required for commercial banks. This plan was supported by the government's designation of a new legal form (Entidades de Desarollo Para la Pequeña y Microempresa [EDPYME], or Small- and Micro-Business Development Entities) to encourage creation of more micro- and small business lending institutions.

EDPYMEs are regulated financial institutions with a minimum capital requirement of only USD $256,000. This status, however, did not allow for the mobilization of deposits. ACP staff were seriously considering this option as they believed it would push them to improve internal adaptation to legal requirements and allow them better access to soft loans (i.e., below-market rates of interest and other favorable terms) and funding from international financial institutions such as the Inter-American Development Bank (IADB).

The plan to become an EDPYME was presented to the superintendencia de Banca y Seguros (SBS, or the Peruvian bank supervisor), and the application was approved. However, in 1996, the Peruvian government decided to support the microbusiness sector by creating the legal conditions and environment that permits special purpose microfinance, deposit-taking banks.

Beginning in 1996, ACP carried out series of business plan feasibility studies over an 18-month period to assess the legal and business viability of becoming an EDPYME and to develop an operational plan. This process helped ACP identify several investors in the new venture, including Profund, a Latin American venture fund specializing in microfinance investments; and ACCION International. With their support, ACP made formal representation to the bank supervisor, who saw the potential of ACP and began to investigate a third regulatory option that would allow the institution to offer a full range of banking services, including deposits. This resulted in the creation of a Mibanco, a privately owned, special purpose microfinance bank.[2]

Figure 2: Fund Sources



FIVE INVESTORS: $14 MILLION IN CAPITAL

In 1998, ACP (together with the ACCION International Gateway Fund, PROFUND and two private Peruvian commercial banks: Banco Wiese and Banco de Crédito) came together to form Mibanco.[3] (See Table 1 for details

[2] For more information on the creation of Mibanco, see "The Transformation of Acción Comunitaria del Perú (ACP) to Mibanco," USAID Microenterprise Best Practices, October 2001, http://www.microlinks.org/ev_en.php?ID=7505_201&ID2=DO_TOPIC

[3] The ACCION Gateway Fund, LLC, invests in microfinance institutions with a proven track record of financial viability. Capitalized at over USD $5 million, the fund makes equity, quasi-equity, and debt investments in MFIs in Latin America and the Caribbean. The Gateway Fund currently holds shares in BancoSol (Bolivia), BanGente (Venezuela), Financiera Compartamos (Mexico), FINAMERICA (Colombia), Mibanco (Peru), Financiera El Comercio (Paraguay), and SogeSol (Haiti). The Gateway Fund is managed by ACCION's Financial Markets and Services Department.

on Mibanco's shareholders.) The Corporación Andina de Fomento (CAF) purchased 3.82 percent of shares in Mibanco in 1999. By 2001, looming conflicts of interest caused the two commercial banks to sell their shares. By the end of 2002, ACP held 66.4 percent of Mibanco, while Profund and ACCION together held 24.2 percent, with private investors totaling 3.1 percent of capital.

TABLE 1: ORIGINAL SHAREHOLDERS IN MIBANCO

Institutional Investor	Type of Institution	Ownership	Primary Motive(s)
ACP	Microenterprise NGO	60.0%	Microenterprise development
ProFund S.A.	MFI investment fund	19.0%	Microenterprise development and profitability
ACCION International's Gateway Fund	MFI investment fund of MFI support NGO	7.0%	Microenterprise development and profitability
Banco de Crédito	Commercial bank	6.6%	Learn about microfinance, profitability
Banco Wiese	Commercial bank	6.6%	Learn about microfinance, profitability

Source : Class & Asociados S.A.

ROLE OF SHAREHOLDERS IN THE HISTORY OF MIBANCO

Early shareholder support of Mibanco was essential to the growth of the institution. By the late 1990s, ACP deposits totaled about 16 percent of all portfolio capital. Equity provided over 50 percent of portfolio capital, 60 percent of which ACP owned. Shareholders further demonstrated their commitment to the institution's development by not taking dividends to investors until 2003. As of 2003, when additional capital was no longer required to finance the growth of operations, Mibanco instituted a policy of paying up to 75 percent of earnings to shareholder dividends.

MIBANCO FUNDING STRATEGY

Once bank status was acquired, the institution set in motion a funding policy with three objectives: to ensure financing of the growth of assets, diversify funding sources, and extend the term of liabilities. The institution began the strategic journey from dependence to independence with four principal sources of capital. As noted, Mibanco's initial funding came from its principal shareholder, ACP, and retained earnings. COFIDE, a national development funding source, figured significantly by providing 30 percent of Mibanco's funding. By contrast, deposits represented only 3 percent of funding in 1999 and came largely from Mibanco employees.

TABLE 2: MIBANCO PRODUCTIVITY INDICATORS					
Year	**Personnel**	**Number of Savers**	**Savings (USD)**	**Savers/ Staff Member**	**Savings / Personnel (USD)**
2000	466	4,430	9,425,000	10	20,225
2005	1,436	57,142	147,645,770	40	102,817

DIVERSIFICATION STRATEGY

Beginning in 1999, Mibanco began increasing contacts with international institutions and organizations, including the IADB and the International Finance Corporation (IFC), the private sector finance arm of the World Bank. It also began serious networking with international microfinance leaders, including leading development agencies such as the Consultative Group to Assist the Poor (CGAP). This effort was intended to establish Mibanco's international brand image and complement simultaneous work at the national level to diversify funding.

Simultaneously, Mibanco worked to improve operational efficiencies in order to meet international "best practice" standards.

Mibanco's first national diversification move was to seek lines of credit from local commercial banks. After some negotiation, bank lines were ultimately not taken by Mibanco, given the high-risk premium that banks wanted to charge.

The institution's second move was to broaden its deposit customer base. This was considered an expensive source of funding at the time, given that the interest rate paid on savings accounts was at 9.85 percent (end of 2001). But Mibanco staff believed that, in the long term, this measure would decrease the risk associated with dependence on few sources of funding. Initially, the bank's effort focused on term deposits. This source of funding was preferred for the diversification it offered as well as its good market visibility and reasonable funding security.

However, sales, transaction, and financial costs to raising term deposits were significant relative to other competing forms of capital. As a new financial institution with a weak national banking institution brand, Mibanco had to pay high interest rates on term deposits. Rates for 12-month deposits in late 2002 were 18 percent (in Soles) and 7 percent to 12 percent in U.S. dollars. By comparison, commercial business loans averaged 18 percent in Soles or 10 percent in U.S. dollars at the end of 2000. By late 2005, rates had dropped to just over 6.9 percent in Soles and 5.5 percent, translating into 10.41 percent in U.S. dollars, or only about 2.4 percent

MANAGING CHANGE

In 2000, Mibanco's Finance Department established a Treasury department from an existing but very simple cashier structure. The department has since grown to 10 people, most with commercial banking experience.

Four people are now in charge of Mibanco's financial communication and liabilities management. They are responsible for large deposit client relations and sales. The team also provides input on savings product rates, terms, and conditions.

effective, after inflation of 3.8 percent. This compares to an average cost of funds for the bank of around 7.1 percent at the close of 2005.

Key to its deposit strategy was increasing branches and branch sales. Between 2004 and 2006, Mibanco grew its branch network from 30 to 74. Simultaneously, the bank began to focus on increasing productivity as a means to increase volume while decreasing fixed overhead costs. Table 2 shows the bank's increased productivity over five years in growing its deposit base.

Expanding sales outlets and improved productivity, combined with the launch of new savings products, allowed the institution to continue growing liabilities with the public in the past several years. Deposits increased from USD $9.4 million in December 2000 to USD $147 million in December of 2005.

By the end of 2006, term deposits represented 80 percent of the liabilities with the public and 60 percent of all liabilities, up from 21 percent in 2000. Globally, deposits of more than three months represent 35 percent of these liabilities (see Figure 2).

Mibanco's Treasury department also manages institutional deposits from mutual funds, pension funds, public institutions, and private banks. Some clients include the National Housing Fund, National Health Fund, the Retirement Fund of the National Police, and armed forces pension money. To avoid concentration risk, Mibanco has set a maximum deposit size of USD $3 million.

To attract institutional investors, Mibanco offers a premium over rates paid to individual depositors. This is consistent with the bank's focus on diversification and maintaining a balanced distribution of term deposit liabilities, which are traditionally rather volatile. In this sense, Mibanco effectively places a premium on diversification over financial costs. At the same time, its focus on term deposits helps to decrease overall deposit sales and transaction costs, compared to a purely demand-deposit focus, which offers greater core funding stability but incurs higher management costs.

TABLE 3 COMPARATIVE COSTS OF FINANCING		
	2000	**2005**
Return rate on deposits	18% in Soles 7% in USD	6.12% in Soles 4.06% in USD
Debt rate to Financial Institutions	Soles : Max : 18.25% USD : From 7% to 12%	Soles : 6.96% Average USD 10.41% Average of USD 7.095
Bond rate and/or CDN	—	4.90% / 5.06%

COMMERCIAL LINES OF CREDIT AS A BACKUP

In 2002, Mibanco attempted to negotiate a USD $3 million, short-term line of credit with Banco de Crédito del Perú (BCP). Lacking a strong commercial record, Mibanco was required to source a third-party guarantee, which it secured from ACCION International Bridge Fund, a sister fund of ACCION Gateway that holds shares in the bank. The line was not ultimately activated, however, as Mibanco staff found the 10.5 percent rate too high. On the positive side, Mibanco was able to establish a relationship with BCP that could serve as a basis for future negotiations.

ISSUING CORPORATE BONDS

Mibanco's strategy to this point had been to increase liabilities through deposit growth, and by managing different credit lines with national and international entities. Its next move was to the capital markets.

Early in implementing its diversification strategy, Mibanco determined that it would enter the commercial bond market. Bond issuance was also aimed at lowering Mibanco's overall cost of funds by offsetting the high cost of deposits. The bonds were intended to help to lever shareholder capital while enhancing the bank's image in commercial capital markets.

The first bonds, issued in 2002, came after great efforts to receive an international rating for the issues in order to facilitate sales to domestic institutional investors. While Mibanco's performance alone was sufficient to qualify the bonds for institutional investors, Mibanco sought partial third-party guarantees from USAID in 2002 and CAF to reduce the cost of financing. Guarantees on the first two issues were also required to ensure market interest and to smooth a transition to future bonds issued on Mibanco's performance alone. The final issue in October 2003 was without a guarantee.

Mibanco's first bonds were issued in an unstable international environment caused by Lula da Silva's election in Brazil. Mibanco staff refused to wait for the situation to settle, and chose to "force" the market. According to the financial director, Mibanco would have obtained a better rate had it carried out the issuance at a later time.

Between December 2004 and November 2005, Mibanco issued Negotiable Deposit Certificates for USD $29.5 million, reaching an average rate of 4.82 percent. Commonly referred to as certificates of deposit (CDs), these are tradable debt instruments backed by the equity and credit rating standing of the issuer alone. Mibanco's CDs were termed at one year and as a result were relatively low priced. Many of their long-term deposit clients, institutions, and individuals, purchased the bonds. Unlike term deposits, tradable CDs offered clients greater liquidity, and they could be purchased at a discount to term deposit rates. As such, the CDs offer Mibanco an investment instrument complementary to its deposit products and bond issues.

TABLE 4: MIBANCO BOND ISSUE DETAILS

	Issue One	Issue Two	Issue Three
Amount	**USD $5.8 M**	**USD $5.8 M**	**USD $2.9 M**
Investors	17.5% mutual funds 82.5% pension funds	32.5% mutual funds 28.8% public entities 26.2% pension funds 10% banks 2.5% insurance agencies	21.1% mutual funds 59.4% public entities 19.5% pension funds
Rating	AA	AA	A+
Guarantees	50% USAID	50% CAF	None
Rate	12%	5.75%	5.75%
Term	2 years	2 years 3 months	1 year 6 months

SUMMARY

Diversification continues to play a significant role in Mibanco's funding strategy. Cost of funds is important, but developing significant and stable savings deposits as a part of a well diversified source of funding is of primary concern. Thus, Mibanco's ideal composition of debt is to have about 50 percent from deposits from small-scale savers, 25 percent from institutions, and 25 percent from commercial bonds. Bonds and institutional CDs, whether tradable or term, are perceived as more expensive but can add to concentration risk, an element factored into liquidity risk policy-making and funding decisions.

Mibanco's experience demonstrates the need to anticipate and seek funding based on an appropriate and disciplined strategic plan. Seeking out third-party guarantees for lines of credit was strategically important as a means to establish relationships with bankers, and was critical to initial bond issues.

However, the quality of Mibanco's assets, or its own market credibility, has been critical to powering its institutional term deposit and negotiable CD sales, which form a significant part of its diversification strategy. Without good portfolio performance, a policy of conservative provisions, and strong capitalization, institutional investors would likely not be interested in Mibanco products.

By limiting exposure of any one depositor to USD $3 million, Mibanco limits concentration risk. It also ensures that the bank will have a wide network of current and past investors to tap in the event of liquidity needs, and generally improves the institution's market image and brand. Corporate bonds achieved much the same effect while simultaneously lowering the bank's average cost of funds. Also, because the bonds require institutional ratings, Mibanco established its position in the financial community and commercial capital markets.

As the bank's financing management increased in sophistication, its funding strategy was managed initially by senior management, then by the Finance department, and finally to the Treasury department. An increased sales force for institutional CD and term deposits was a core investment. Implicit in Mibanco's strategy was consistent and intense financial communication and customer service. This communication, the rating, and the partial guarantees worked to decrease the market's expected risk premium to investing in a smaller domestic bank operating in a non-conventional sector.

SECTION TWO:

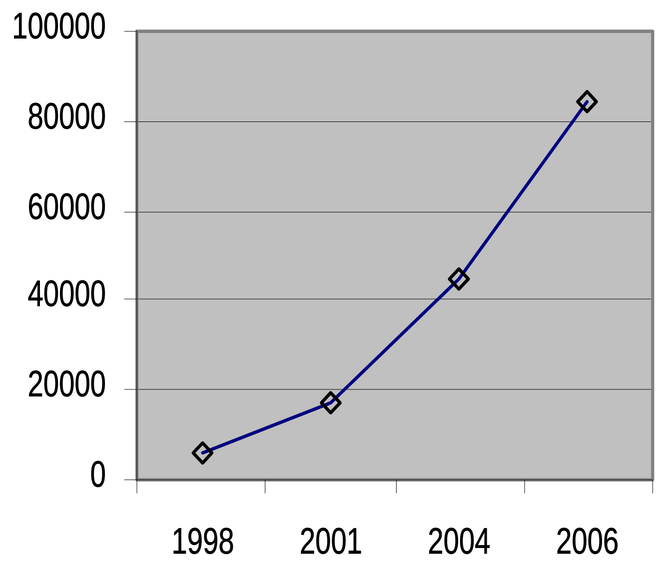
EDYFICAR: LEVERAGING DIVERSITY FROM A DEDICATED SHAREHOLDER

CARE International began operations in Peru in 1970 after the devastating earthquake in the Peruvian highlands in the department of Ancash. In subsequent years, CARE Perú evolved to become directly involved in a number of social projects in Peru, mostly in rural areas. Through these projects, it helped provide the population with services for health, education, construction, and management of social and economic infrastructure. In urban areas, the *comedores populares* (soup kitchens) that had emerged in response to the severe economic crisis were complemented by income-generating programs, including a rotating loan fund for women's groups and direct credit for microenterprises.

In 1994, the Peruvian government established a new, non-deposit-taking, regulated financial entity known as Entidades del Desarollo de Pequena y Mediana Empreasas (EDPYME, or Entities of Development for the Small and Microbusiness). The assets of CARE's primary microcredit program, Programa de Créditos de CARE Perú, were transferred into EDYFICAR, an EDPYME owned wholly by CARE. The organization was incorporated in 1997 and began operations in 1998. EDYFICAR has seen strong and constant growth from inception (see Figure 3) and by the end of 2006, it had grown to serve more than 84,000 clients with a portfolio of USD $84 million.

EDYFICAR's funding history has relied primarily on its main shareholder, CARE, and access to funding from government-owned second-tier financial institutions such as COFIDE. EDYFICAR's liabilities profile relied heavily on national development bank and organization funding and has sought to diversify funding through loans from international institutions. With growing foreign currency exchange risk and cost, EDYFICAR is now seeking to reduce foreign currency debt and is working on accessing national private capital markets.

Figure 3: EDYFICAR Active Borrowers



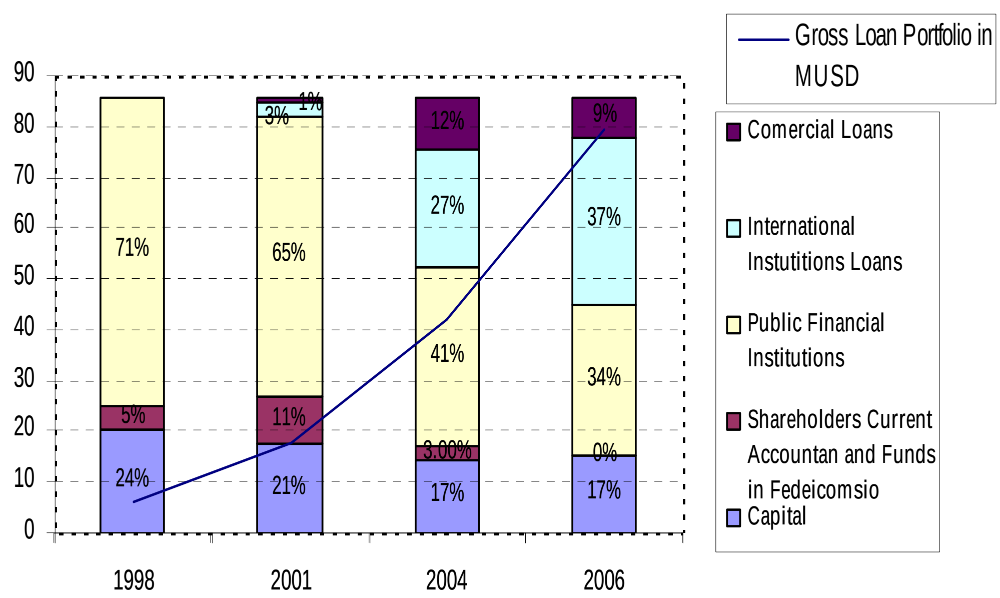
STATE FUNDING SUPPORT

EDYFICAR's funding history and strategy is influenced significantly by the limitations and opportunities afforded by a strong supporting shareholder and wholesale funding from state-owned financial institutions. Motivated by the relative weakness of this structure, EDYFICAR's funding strategy has focused on diversification, with a gradual evolution towards commercial sources of capital.

In 1998, 71 percent of EDYFICAR's liabilities were from FONDEMI and the Special Unit AID of the Ministry of Economics and Finance. FONDEMI is a financial services arm of Programa Perú Emprendedor del Ministerio de Trabajo y Promoción del Empleo (the Peruvian Enterprise Program of the Ministry of Labor and Promotion of Employment, or MTPE). MTPE is managed by COFIDE through a trust, with resources coming from the European Union and contributions from the Peruvian public sector. The shareholder CARE Perú also helped with the original funding of EDYFICAR with a short-term loan in 1998 of USD $207,000 at 5 percent, and another loan in 1999 of USD $911,000 at 10 percent. COFIDE provided further funding from its own resources and quickly became one of EDYFICAR's main financing sources.

Despite EDYFICAR's portfolio growth and success, in 2001, 74 percent of its non-equity liabilities came from government sources and COFIDE. A further 19 percent came from CARE. See Figure 4 for details on EDYFICAR's sources of funding.[4]

Figure 4: EDYFICAR Sources of Funding



EDYFICAR's strategic funding priority from 2000-2006 was aimed at reducing dependence on public funds by taking loans from international funds seeking to invest in microfinance institutions. This strategy option meant dramatically increasing the institution's exposure to foreign exchange risk and related risk coverage costs.

In 2004, EDYFICAR took important steps to execute its strategy when it received three long-term loans: a USD $3 million credit line from Blue Orchard Microfinance, a USD $1.5 million loan from the Belgian Investment Company for Developing Countries (BIO), and another USD $3 million from IFC (senior debt). Additionally, EDYFICAR took an additional USD $1 million convertible subordinated loan from Microvest, a private MFI-focused specialty investment fund owned partially by CARE.

[4] A *fidicomiso* (funding source designated in red-violet in Figure 4) is a close equivalent to a foundation that holds funds in a tax-free status, usually invested in a social purpose.

The loan was converted to equity in December 2003 for an 8.5 percent share of the company.

EDYFICAR's following of an international finance strategy led to foreign-denominated debt totaling 39 percent of liabilities by 2005. Debt from public institutions decreased, but remained high at 34 percent. Also, more than 52 percent of all debt was concentrated in three institutions: COFIDE, FONCODES, and Blue Orchard.

During this period, EDYFICAR investigated but chose not to accept traditional commercial bank lines of credit, as it found that rates and conditions (security collateral) were not favorable compared to other sources of funding. According to EDYFICAR management, banks do not understand the risk of an EDPYME and lines will probably not be sourced in the future.

EDYFICAR is in the process of becoming a financial institution with deposit-taking capacity. The institution considers individual deposits as customer service rather than a significant source of funding because of the high cost of deposit management. They estimate that deposits could comprise 8 to 10 percent of liabilities after two years of initiating services.

PREPARING CORPORATE BOND ISSUES

It is in this context that EDYFICAR has shifted its strategy away from international funding and towards securing sufficient national funding, in order to reduce risks related to foreign exchange and further diversify its funding base. To carry out this strategy, EDYFICAR is planning to turn to the Peruvian capital markets and issue its own bonds.

TABLE 5: EDYFICAR FUNDING COSTS (2006)

Cost	Rate
Loans from governments agencies	6.00% - 8.25%
Loans from foreign financial institutions	5.50% - 11.63%
Cost of exchange rate coverage	5.20% - 6.55%

In addition to raising funds and increasing funding diversity, bonds are considered a way for EDYFICAR to open the doors to local private capital for the first time in a significant way. More than any action EDYFICAR has taken in the past, issuing bonds will create a significant market-based credit reference that will allow the institution to negotiate better funding terms conditions and establish a solid credit history. Raising significant volumes of capital through the bond market is also less expensive than similar amounts from commercial banks because institutional investors have lower transaction costs and higher risk tolerances. This factor, among others, will likely drive down the cost and improve the terms of commercial bank lines required for liquidity management.

To prepare for its entry into the private capital markets, EDYFICAR began early with two risk-rating companies to obtain an international rating — a critical step. Its first rating was undertaken by Class Ratings, a reputed local firm; and the second by Apoyo, a local rater associated with Fitch Ratings, which was a choice that spoke to the needs of national institutional investors. The process began in 2002, with assessments and a rating of the actual bond issue by a local rating company. The process resulted in a rating of "A" for the bond issue. A rating of AA- is the minimum for institutional investor purchase of the issue.

EDYFICAR's options at this point were to wait until operations improved, or to find a third-party guarantee to bring the rating to the minimum level. IFC provided a 30 percent guarantee on the issue and made EDYFICAR a convertible loan (i.e., one that can be converted to equity). Subsequently, IFC decided to convert its USD $2.5 million loan to shares.

Having broken into the bond market in 2002, EDYFICAR is confident that its issue planned for 2007 will be successful. The issue was to begin in July 2007, and the bonds were to be in local currency in the equivalent of USD $50 million. The bonds will have two-year amortized terms, and institutional investors are the anticipated buyers. This volume is relatively significant, based on the total current asset base of 303 million Soles (approximately USD $95 million) at the end of 2006.

EDYFICAR reports that the market will want a leverage level of less than 7 percent and a portfolio at 30-day risk of less than 5 percent. The institution is expected to have at least 3 months' cash at hand to finance operations, as well as backup credit lines for six months of coverage.

PRIVATE CAPITAL IMPERATIVES

Managing EDYFICAR's increasingly complex funding and cash operations is the responsibility of a three-person Treasury department. The organization has a finance director with commercial banking experience and over 6 years' tenure at EDYFICAR. The institution also has a Risk Unit with the technical capacity to handle risk management activities and manage bond structuring.

A high level of transparency is required to issue bonds and raise capital more generally. EDYFICAR received a transparency award from CGAP, which earned the institution important credibility. The existence of a solid and credible business plan has proven a capable sales tool.

THE ROLE OF THE SHAREHOLDERS

CARE Perú has committed to capitalizing the maximum amount possible of the annual profits. CARE tends to capitalize almost all of its profits to maintain the proper leverage.

Equity strengthening is a main goal for EDYFICAR between 2006 and 2010. The IFC committed to EDYFICAR through convertible subordinated debt and will be contributing its capital. The Belgium Investment Organization, a development investment agency of the Belgian government, is currently negotiating to become an EDYFICAR shareholder. These investments will strengthen the equity base of the institution, and should result in better access to debt from a variety of sources.

At the same time, the participation of CARE Peru will be reduced over time, as new strategic shareholders familiar with microfinance and sharing EDYFICAR's poverty alleviation mission will be incorporated. CARE's goal is to progressively reduce its participation to a 51 percent controlling interest.

TABLE 6: SHAREHOLDERS AT THE END OF 2006

Shareholder	Participation % Total Shares
CARE Perú	84.3%
Microvest	7.8%
CARE Canada	0.1%
Others	7.8%
Total	**100%**

WAY FORWARD: CAPITAL MARKETS AND DEPOSITS?

EDYFICAR's strategy has been conditioned by the imperative of diversifying sources and avoiding high funding costs. The incorporation of loans from international institutions was the first step towards diversification, despite its relatively high costs. At the same time, EDYFICAR rejected use of expensive commercial bank lines of credit, consciously "trading off" cost-of-fund concerns against liquidity-risk considerations.

Instead of using lines of credit as a first stop in private capital markets, EDYFICAR has chosen to focus on corporate bonds. Bypassing the banks has several benefits, including financing costs, but it will also allow the organization to establish market based credibility and benchmarks for negotiating future loans. It will also avoid exorbitant risk premiums inevitably charged to establish a credit history with commercial banks. The institution continues to have interest in being able to take deposits, but given the existing regulatory requirements and governance options, EDYFICAR does not anticipate offering such services in the short term.

Clearly, the role of EDYFICAR's main shareholder and new shareholders have been central to the success of the institution, not only for their connections and credibility, but CARE's commitment in particular to reinvest profit for an extended period of time. A solid financial structure and committed shareholder base has been and will continue to be crucial for EDYFICAR.

SECTION THREE:

COMPARTAMOS: LESSONS LEARNED, DISCIPLINE, AND THE TRANSITION TO PRIVATE CAPITAL[5]

In 1990, a small group of students working in social development in Mexico joined efforts to start Asociación Programa Compartamos, a non-governmental organization providing credit to microenteprise in the states of Oaxaca and Chiapas.

Compartamos was financially self-sufficient by 1997, and in 1998, a group of investors (including the group's founders and ACCION International, an international microfinance support association) requested authorization to operate as a regulated financial intermediary. This led to the October 2000 creation of Financiera Compartamos as a regulated, special purpose, non-bank financial institution, known as a *sociedad financiera de objeto limitado*

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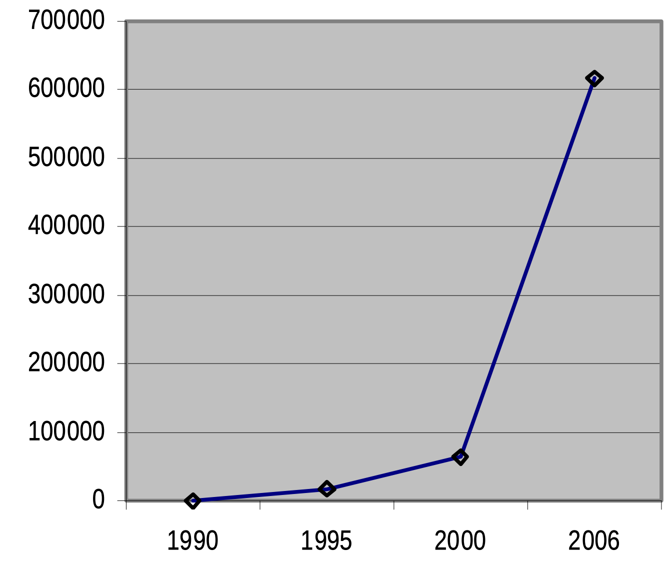
[5] This case study does not include information on the Compartamos spring 2007 initial public offering.

(SOFOLE). Financiera Compartamos served as a non-deposit-taking entity limited to microfinance lending. The company transformed into a full commercial bank in late 2006.

Compartamos has seen a steady growth of clients since its inception. The company's lending methodology for low-income women in rural and semi-rural areas is a combination of the methodologies in group lending of Grameen Bank in Bangladesh and FINCA in El Salvador. Unlike many institutions, Compartamos has had a structured and disciplined commitment to a long-term private capital funding strategy, which has fueled its tremendous growth since 2000.

Figure 5: Compartamos Active Borrowers



DONOR-SUPPORTED BEGINNING

Compartamos had significant donations of grant funding, much of which was used for capacity building. To date, Compartamos has received USD $4 million in grants sourced at different phases of its development.

The first grants focused on operational capacity building, beginning with a USAID grant of USD $50,000 for a pilot microfinance project in 1990. In 1993, the IADB granted USD $150,000 for capacity development and lent another USD $500,000 for portfolio funding. These early grants were important for building capital investments in an institution unable to provide a credit history.

> **COMPARTAMOS EXECUTIVE TRAINING AT BOULDER**
>
> When Compartamos requested a five-year donation in 1995 to train personnel, USAID proposed instead that the management team of Compartamos take a microfinance course at the Economics Institute of Boulder, Colorado. Ninety percent of the team took the course, improving the skills of many top management executives.

Over the next five years, Compartamos received US$300,000 from six different sources, not including a personal donation from the Mr. Harp Helu, President of Banamex (a personal advisor to Compartamos) for US$1 million to accompany a US$300,000 donation from Banamex.

CGAP made a USD $2 million tranched grant to Compartamos, contingent on performance results over a three-year period. The first disbursements were used to implement accounting, communication, and management information systems. Subsequent disbursements were to be used for further management and systems capacity building, but were made contingent on having a portfolio at risk over 30 days of less than 10 percent, client growth of more than 25 percent annually within three years, and achieving a positive return on assets within three years.

In 1999, Compartamos joined ACCION International to request an innovation grant from USAID. The financing of USD $2 million was paid out through ACCION in 3 parts: USD $800,000 committed to the capital of Compartamos, a USD $1 million loan from ACCION Gateway Fund to Compartamos in the form of subordinated debt, and USD $200,000 for technical assistance, made expressly so that the MFI could begin operating in Mexico City and reach new markets.

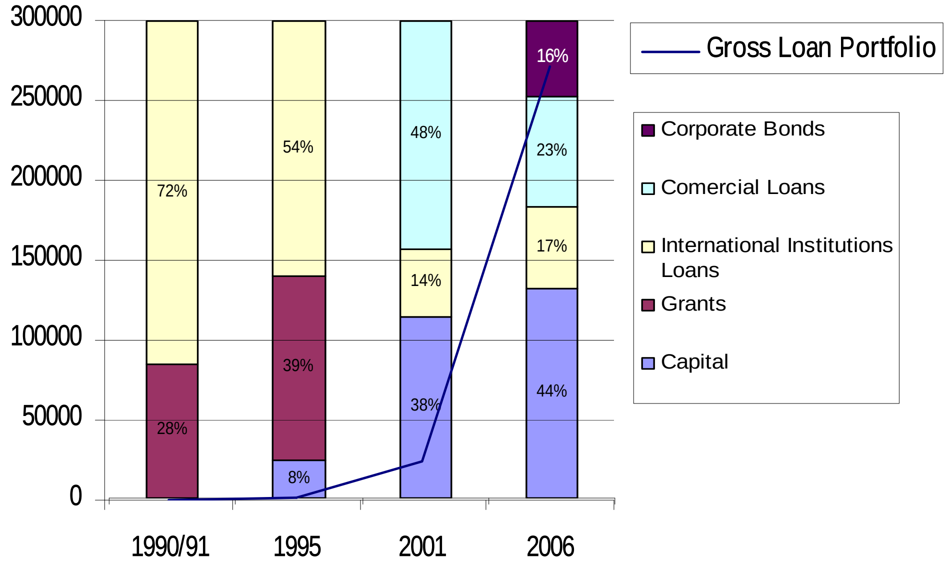
TRANSFORMATION: THE ROAD TO ACCESSING PRIVATE CAPITAL

Institutional strengthening allowed Compartamos to begin transforming into a SOFOLE in 1998. The transformation took place over a two-year period, during which the minimum capital requirement for SOFOLEs was increased and Compartamos was forced to ask shareholders to increase their share capital. By the end of 2000, Compartamos had raised USD $5 million through a number of shareholders, including Profund, ACCION, IFC, the original NGO, and private individuals.

During the process of transformation, the company neglected fundraising while experiencing dramatic growth, leading to a serious liquidity crisis. This crisis was a first for the Compartamos board of directors, and it faced the significant challenge of rapidly refinancing its portfolio.

Compartamos was in an extremely vulnerable position in seeking commercial bank loans, despite excellent financial statements, solid capitalization, and good profitability.

Figure 6: Compartamos Funding Sources, 1990 to 2006



Dogged by the high-risk perception of the microfinance sector in general, Compartamos' request for funding from Banco Bital, a large Commercial bank, was rejected on the grounds that it was unable to comply with the bank's security collateral requirements (100 percent coverage).

Because of Compartamos' operations in rural zones, the MFI was able to rapidly negotiate a 70-percent guarantee with FIRA, a national agricultural development bank, with Compartamos backing the remainder. Together with the Compartamos' contacts through the banking sector, facilitated in large part by its relationship with Banamex, these guarantees were deciding factors for an eventual MXN $50 million (USD $5 million) line of credit from Bital. Despite 100 percent credit risk coverage, lenders still charged a floating rate of CETES[6] plus 8 percent, or approximately 13 percent, at the time.

In this period of institutional transition and growth, Compartamos learned a major lesson: Preparing the market and creating links and relationships with managers in commercial banking is an essential part of liquidity management. The "market" must be prepared in advance and or credit lines must be in place to ensure they are available in the event of liquidity demands. The complete transparency of Compartamos in past years (i.e.,

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[6] CETES (Certificados de la Tesorería de la Federación, or Certificate of the Treasury of the Federation of Mexico) are treasury bonds whose price provides a benchmark for debt instruments. Bonds come in 28, 91, 182, and 364 terms.

TABLE 7: SHAREHOLDERS (MARCH 2007)	
Entity	**Participation % Total Shares**
ACCION International	20%
IFC	10%
Fundación Compartamos	39%
Private Shareholder Corporations	18%
Private Shareholder Individuals	6%
Others	7%

distribution of financial statements) also helped, as did the presence of strong shareholders.

EMERGING STRATEGY

Developed in part before and solidified after the liquidity crunch, Compartamos' funding policy rejected the comfort of grants and focused on diversification of funding sources. Cost of funds, while remaining important, was no longer the priority; instead, convincing private capital to take risks by reducing guarantees, creating a credit history, and diversifying funds sources through a strategy to reduce dependence and build negotiating power.

This strategy led Compartamos management to also avoid loans from commercial banks. Determined to honor its diversification policy and to establish its market qualifications, Compartamos rejected bank loans that required excessive guarantees. Disciplined negotiation eventually allowed Compartamos to build a credit history with commercial funders and to move from totally guaranteed loans to partially guaranteed loans to loans without guarantees.

BONDS FIRST

Compartamos' diversification and private capital strategy was underpinned by healthy capitalization, which is a necessary component for a successful financing strategy. Solid performance further reduces risk to investors, and together with a solid capital base, this formed the basis of Compartamos' negotiation stance with funders. This approach, however, requires significant commitment from funders, as it works against the advantages and goals of traditional shareholders that seek strong leverage effects on their capital (i.e., higher capital-to-asset ratio means less profit per share).

This commitment was strengthened when, in the early part of this decade, Compartamos' shareholders decided not to distribute profits for the foreseeable future. Low leverage offered security to lenders and demonstrated that management and shareholders were committed to a long-term vision for the business.

TABLE 8: COMPARTAMOS BOND OVERVIEW

Date of Issue	2002	2002	2004	2004
Amount	150 MXP (USD $15 million)	50 MXP (USD $5 million)	190 MXP (USD $16 million)	310 MXP (USD $27.5 million)
Investors	20% institutions 80% individuals	50% institutions 50% individuals	Individuals and Banks	Institutions 88% Individuals 12%
S&P Rating	A+	A+	AA	AA
Guarantees	None	None	34% IFC	34% IFC
Rate	CETE 91 days + 2.5%	CETE 91 days + 2.9%	TIIE 28 days + 1.5%	TIIE 28 days+ 1.17%
Term	3 years & 3.5 years	3 year	5 years	5 years

MOVING PAST COMMERCIAL BANKS

Compartamos' longer-term strategy, which allowed them to avoid grants and reject commercial bank finance as an ongoing source of finance, resulted in a plan to issue corporate bonds in the public capital market. Because bond issue ratings rely more on cash to pay and less on traditional asset-backed securities, Compartamos would be able to create new, market-driven credit references that would ultimately support non-guaranteed borrowings from banks and establish the bank as a "normal" player in the capital markets.

Compartamos' work to issue bonds covered multiple years, beginning with establishing a relationship with Standard & Poors (S&P), from whom it eventually secured a rating. Additionally, Compartamos was supported by CitiGroup.

The first two bond issues by Compartamos were modest in size (see Table 8, page 18) and were made without third-party guarantees. The strategy was to establish an independent institutional market presence. Thanks to an "A+" institutional rating from S&P, the first two issues were fully subscribed by a range of investors (20 percent institutions and 80 percent high net worth individuals). These investors accepted the institutional risk of Compartamos with no added guarantees — in other words, with a risk comparable to that taken by shareholders.

The second issues were larger (MX$310 million, or USD $27.5 million) and were supported by an "AA" rating from S&P. The issues also had a 34 percent guarantee from the IFC. The guarantees were meant to attract more institutional investors, particularly growing privately managed retirement funds, which required a higher rating. This objective was accomplished, and 80 percent of the bond was purchased by such investors.

Attracting these investors is an achievement both for Compartamos and microfinance in general, as they establish the low-income financial market as a credible investment option for investors seeking to optimize a conservative profitability and risk position. This sends a significant signal to the rest of the capital market that microfinance, as a market, is a viable investment.

For Compartamos, the bond issue represented a significant diversification of funding sources, and its market credibility helped establish an important negotiation tool with other funders. The issue also had a significant positive effect on the institution's overall cost of funds, which declined from 16 percent in 2001 to just over 11 percent in 2006 (see Table 9).

TABLE 9: EVOLUTION OF THE AVERAGE FUNDING RATE (USD MILLIONS)

	2001	**2006**
Commercial Loans	14	112
Development Institutions	4	48
Average Interest Rate	16.30%	11.10%

COMPARTAMOS: THE BANK

Compartamos received a license to operate as a commercial bank in 2006. With this status, the institution can accept deposits. Because of the cost of managing deposits (particularly operating costs, which are estimated at 5 to 7 percent of total deposits plus interest or finance costs), Compartamos is not contemplating rapid growth in deposits as a source of funding. Bank management feels that it might reach 30 percent of funding in the medium term. This is a relatively modest proportion, given that most small banks target about 70 to 80 percent. Compartamos views deposits, as a result, as an important customer service as much as a low-cost funding strategy.

EVOLVING OPERATIONS

Throughout the events of the last seven years, Compartamos has made a number of significant internal changes to adapt to and execute its funding strategy.

One of the main operational changes was attitudinal: Compartamos considered participants on both sides of the balance sheet as clients. This focus means that sales, communication, tracking, and relationships with lenders, investors, and related stakeholders were managed from a commercial perspective. Compartamos did not establish a formal investor relations program, but certainly, treating funders as clients was a central part of its funding strategy.

The transition to the capital market also demanded that Compartamos staff understand financing in a different way than they had in the past. Early on in the transition away from grants and other subsidized funding, Compartamos implemented an internal accounting system that imputed the cost of capital by taking into account real market rates. This helped correct the effects of subsidized loans and modeled institutional efficiency under purely commercial conditions. The system was part of the aforementioned change to the institutional ethos; no longer happy to depend on international grants, Compartamos management prepared to take the path toward autonomy, and toward building market credibility.

Some structural changes were implemented as a part of Compartamos' increasingly complex financial management. In 2002, the board of directors established a Treasury department, which today has 10 staff members responsible for financial and treasury information, management, and communication. Also, the organization began to fill top finance positions from the conventional commercial and investment banking industry.

IDEAL FUNDING STRUCTURE

Compartamos' ideal funding structure is 40 percent national bank debt, 40 percent stock liabilities, and 20 percent from international financial institutions. A general debt goal is to maintain less than 25 percent of all liabilities from foreign sources, with 100 percent foreign exchange coverage.

At year-end 2006, 59 percent of the institution's debt was long-term and it was not using its portfolio as a collateral guarantee. Of this debt, 95 percent is held in Mexican pesos with the remainder in U.S. dollars, with 100 percent exchange coverage. Lines of credit and sources of loans are diversified. The three largest creditors hold 17 percent, 12 percent, and 11 percent respectively, or a combined total of 40 percent of all liabilities. Over 50 percent of Compartamos' lines of credit are in pesos, 100 percent of its lines in dollars are open, and less than 50 percent of available credit has been used. As a result, Compartamos has 18 months of operating coverage available to manage liquidity under normal conditions.

SUMMARY: GROWTH AND DISCIPLINE

Over the course of its history, Compartamos made several important strategic decisions charting a course for achieving what it considered an "ideal" funding structure. Pushed both by internal growth imperatives and external market realities, Compartamos recognized that future funding needs must be anticipated and the market prepared beforehand.

The institution's decision to shift away from grant funding, diversify funding sources, and make a transition to private capital was significant and, critically, required strong institutional commitment and discipline. Bringing on financial professionals from the conventional financial sector and support from its board, shareholders, and other stakeholders, financial and otherwise, helped to facilitate this discipline and linkages to private markets.

Underpinning the development and disciplined execution of a strategic funding plan has been strong transparency and investor communications, contributing to its market credibility. The decision to build market credibility was a key part of the funding strategy and set in motion important internal systems and attitudinal changes. The move away from bank finance toward the bond market allowed the institution to leverage its solid capital base and performance, as opposed to relying on liquid asset collateral and third-party guarantees. The success of the bonds recalibrated the "market's" view to the risk of investing in Compartamos and gave the institution stronger negotiating positions with commercial banks and other funders.

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