responsAbility

Microfinance Market Outlook 2015

Growth driven by vast market potential

November 2014

Key findings

- The global microfinance market should once again achieve growth of 15-20% in 2015. Asia is displaying the strongest growth momentum. A particularly impressive development in this region is the revival of India's microfinance market. Central Asia is being impacted by the economic crisis in Russia, leading to a slight slowdown in financial sector development compared to previous years.

- According to the International Monetary Fund (IMF), economic growth in the 20 most important microfinance markets will increase from 4.4% to 4.8% in 2015. This means that microfinance countries will probably grow at twice the rate of developed economies.

- The 32 experts interviewed by responsAbility for this report have not seen any evidence of a backlog in reforms in their respective countries. Instead, they believe that the institutional environment for microfinance institutions (MFIs) is improving – both in terms of regulatory supervision by the authorities and market infrastructure.

- These experts take a critical view of the reduced portfolio quality of MFIs. This calls for stricter risk management on the part of MFIs as well as the asset managers investing in them.

- In terms of financing, local sources of financing are becoming increasingly important. International investors continue to play a major role but MFIs are seeking to focus on a smaller number of stronger financing partners.

Dear reader

The publication of our Microfinance Market Outlook in late autumn of each year has become something of a tradition. It is intended to provide you with an in-depth yet concise outlook for the microfinance markets. As one of the leading independent investors in this area, we are able to use our network of experts across the different markets when producing this report, while also drawing on high-quality key data gathered each month from around 300 microfinance institutions (MFIs).

The fifth edition of Microfinance Market Outlook provides us with a welcome opportunity to look back at the past five years, while also looking forward to the next five. Our review of the last half decade clearly demonstrates the development potential that is to be found in the microfinance markets: While the financial markets experienced a rollercoaster ride and investors were caught on the wrong foot on numerous occasions during this period, the microfinance markets achieved very consistent and reliable growth.

> "The global microfinance market should grow by 15-20% again in 2015."

Although they displayed strong growth rates, the 77 microfinance markets in which responsAbility invests evolved at a steady pace in structural terms, with each phase of their development being clearly visible. This is an encouraging picture that reflects the hard work of hundreds of MFIs.

Investors are, of course, interested in finding out if and how this trend will continue. To evaluate how the microfinance world is likely to develop in future, we conducted detailed interviews with 32 experts from all major microfinance markets worldwide to gauge their expectations. The experts interviewed are decision-makers at MFIs and rating agencies, as well as investors and advisors. We wish to thank the following individuals for their valuable input:

Roberto Andrade (Banco Solidario), Pedro Arriola (Consultant), Carlos Avalos (Vision Banco), Patricio Diez de Bonilla (Banco Compartamos), Nikolas Drude (EBRD), Malkhaz Dzadzua (Crystal), Thomas Engelhardt (LFS Financial Systems), David Ferrand (FSD Kenya), Jeff Flowers (Finca), Tony Fosu (Sinapi Aba), Ralph Guerra (Compartamos Financiera), Jhale Hajiyeva (Azerbaijan Microfinance Association), María Clara Hoyos (Asomicrofinanzas), Hout Ieng Tong (HKL), Emmanuelle Javoy (Consultant), Mejra Juzbasic (Finance in Motion), Mona Kachhwaha (Caspian), Michaël Knaute (Oxus), Kurt Koenigsfest (BancoSol), Anne-Lucie Lafourcade (IFC), Aldo Moauro (MicroFinanza Rating), Clive Moody (dfe Partners), Zaza Pirtskhelava (Credo), Felipe Portocarrero (IFC), Karlygash Raikhanova (KMF), Eric Savage (Unitus Capital), Sanavbar Sharipova (IMON), Alex Silva (Omtrix), Senacheert Sim (PRASAC), Gagik Vardanyan (Kamurj), Arnaud Ventura (MicroCred), Styopa Zakinyan (ACBA).

To assess potential levels of demand over the next five years, we also carried out an analysis of the microfinance markets using a model-based simulation for the period to 2019. The results of our analysis can be found on page 5. In addition, this Microfinance Market Outlook provides a current overview of the investment universe and offers an economic outlook for the target markets in 2015. We have also sought to provide an investor-oriented interest rate outlook and we explore the results of this year's expert survey in greater detail.

As a final point, the publication once again turns the spotlight on India, thus providing continuity in our analysis of this booming market for our readers. The increasing role of private equity investing in the field of microfinance is another pertinent topic that we examine in this Microfinance Market Outlook.

We hope you enjoy reading the publication.

Christian Etzensperger
Senior Research Analyst, responsAbility Investments AG

Microfinance sector: Facts and figures

The aim of microfinance is to build financial sectors that are closely interconnected with the local economy – thus facilitating lending to micro and small entrepreneurs, enabling payment systems to be established and, in particular, creating new savings opportunities for private households. This approach – which is efficient in many respects – enables capital to be put to productive use in the local economy. In other words, the microfinance business contributes to the quantitative growth of other sectors of the economy, such as small-scale industry, construction and trade. This is accompanied by a process of ongoing formalization, i.e. the numerous steps that a provider undergoes as it makes the transition from the shadow economy to becoming a tax-paying enterprise with contractual commitments, as is the norm in developed countries. Consequently, financial sector development provides small enterprises and households with market access – leading to their inclusion in the regional and ultimately the global economy.[1]

The growth of the financial sector is underpinned by companies that provide a range of financial services. If we consider the number of end-consumers that exist, it is clear that the strongest growth potential is to be found in the lower-income segment – the microfinance segment. The providers that are active in this segment are known as microfinance institutions or “MFIs”. However, this generic term now encompasses thousands of providers with different legal statuses that are at varying stages of operational development.

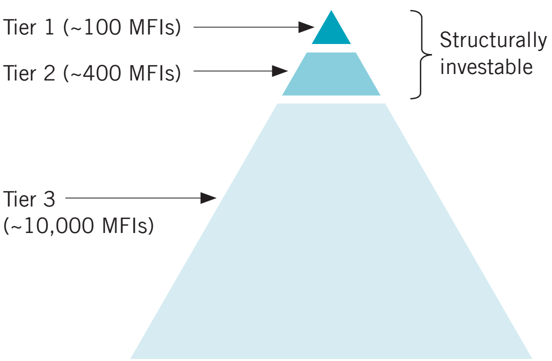
For investors, the only financial services providers that are attractive are those that operate profitably and meet regulatory requirements as effectively as possible. They need to have professional structures and processes in place to fulfil strict requirements in key areas such as accounting and risk management. Around 500 such institutions exist worldwide, spanning around 80 countries. In each market, we focus on those providers that are most successful in serving the needs of low-income households. Like in other sectors, competitive forces naturally also lead to changes in market leadership within the microfinance sector. MFIs are increasingly competing to win the favour of clients and investors, and emerging providers are taking over the market positions of stagnating institutions.

This publication focuses on the group of around 500 well-structured financial services providers that are suitable for investment based on the above-mentioned factors. They can be roughly divided into two groups:

- **Tier 1 MFIs (at least 100):** These institutions generate sustained returns, serve a large and well-diversified client base, and have an experienced management team in place. In regulatory terms, their potential has largely been realized.

- **Tier 2 MFIs (at least 400):** These are smaller and younger MFIs that have developed a viable business model and have already implemented it to a significant extent. They want to develop further in regulatory terms in order to become an officially recognized financial institution in their countries.

Figure 1: Microfinance investment universe



Source: responsAbility Research

[1] See responsAbility Perspectives 2014, pages 10-13, and the webcast “Microfinance is financial sector development” at www.responsAbility.com.

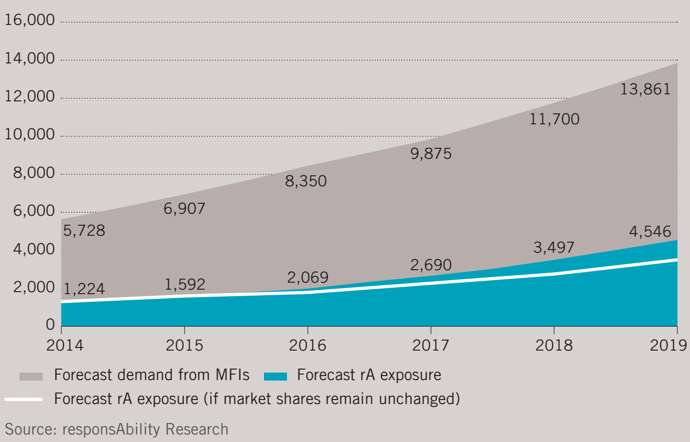
Medium-term outlook: Increasing demand in the years leading up to 2019

The microfinance markets have grown significantly at a global level in recent years – but can investors assume that the favourable environment will continue? All markets that display impressive double-digit growth rates over a number of years are periodically confronted with questions about this growth's sustainability. How much can the market absorb? Will it potentially be oversupplied or undersupplied?

These questions can justifiably also be asked in the case of the microfinance markets. In 2014, the responsAbility Research team performed pioneering work in this area: It carried out a systematic study to analyse the investment capacity of the microfinance markets at a global level for the first time. The study, which took account of country-specific and market-specific factors, delivered encouraging results: The findings suggest that the microfinance market will probably continue to expand at its current rate – which stands at 19.3% p.a. according to our model calculation – for at least the next five years (the detailed results are provided after the description of the model below).

Medium-term growth potential in the area of microfinance can be estimated using a regression model. The question we asked is: "How much will the investment volume considered investable for specialized asset managers grow to in the markets covered by the study by 2019?" We examined this question using econometric modelling. The first step was to identify factors that had a decisive impact on growth in the past. We then used projected values from the IMF and World Bank as input for the model in order to produce a model output based on the mathematically defined context. The linear panel data model estimates the depth of the financial sector for each country using the statistical regression method. The expected ratio of loans to gross domestic product (GDP) is determined in this context. In a further step, a microfinance market simulation was carried out using information from the data platform Mixmarket.org; in the reference year of 2012, it contained data sets from 1,270 MFIs. As the final part of our analysis, we made some corrections so that the resulting investment universe is in line with responsAbility's investment criteria. This ensures that the results correspond to the real investable microfinance market.

Figure 2: Model-based projection of medium-term demand USD million



Source: responsAbility Research

In the case of the 30 most important microfinance markets, we estimate the current market capacity to be USD 5,728 million. Taking this as a starting point, our model considers factors that drive or inhibit growth. Factors that drive growth include GDP growth, the size of the economy and a favourable institutional environment. The factors we consider as growth inhibitors include an increase in savings volumes as a rival sources of financing, as well as a concentration of providers. According to our model, market capacity will continue to grow substantially and in regular stages in the coming years. It should already come close to USD 7 billion in 2015. It is likely that market volume will increase to almost USD 14 billion by 2019 (see grey area in Figure 2).

Within this context, responsAbility could achieve annual growth of 23% based on modelled microfinance market growth and assuming its share of the underlying markets remains unchanged (see line in Figure 2)[2]. In view of the still high absolute market capacity, we are also optimistic that we will be able to further expand our market share if investor interest remains strong – without having significant impact on our competitors. According to this scenario, we will invest around USD 4.5 billion in the 30 most important microfinance markets by 2019 – corresponding to an annual increase of 30%. responsAbility does not, however, set itself any growth targets of this nature. Instead, we will do everything necessary to effectively and sustainably meet demand in developing economies and emerging markets.

The calibrated model is used in the area of active portfolio management at responsAbility. Based on the findings regarding the saturation of individual markets, investment volumes can be reduced in advance. With this approach, responsAbility also indirectly prevents the over-indebtedness of borrowers and observes the United Nations Principles for Responsible Investment (UNPRI).[3]

[2] responsAbility's portfolio allocation to the different markets is not proportional to the size of the markets. This explains the differences between the respective growth rates.

[3] In this respect, responsAbility is one of the largest providers of capital involved in financing the MIMOSA Project – a global field study conducted by an independent body to analyse the risks of overindebtedness with an unprecedented degree of accuracy. The researchers plan to present their initial findings in summer 2015.

Economic upturn in target markets

As a result of the current turbulence in the equity markets, fundamental trends are not being properly recognized. This applies especially to the ongoing recovery of the global economy. According to the latest IMF forecasts, growth across all regions is likely to be even stronger in 2015 than in 2014.

In the case of regional microfinance markets, the conditions are certainly favourable. If the individual regions are taken into account, it can be seen that the US has returned to a robust growth path. This upturn is underpinned by an increase in exports. In addition, the transfer of money by migrants in the US back to their home countries means that the US also serves as an important source of economic momentum for Central America and its Caribbean neighbours. The tentative recovery in the Eurozone has led to a slight easing of conditions in Eastern Europe. Meanwhile, China's soft landing has resulted in solid economic conditions in Asia and favourable conditions in South American countries bordering on the Pacific. It should be noted that certain weaker emerging markets that have a strong weighting in emerging market or frontier market indices are of virtually no significance for the microfinance business. Examples include Venezuela, Argentina, Brazil, South Africa, Thailand and various states in the Middle East. Microfinance markets are not immune to the economic crisis in Russia. This topic is examined in greater detail in the chapter "Pleasing outlook, regional shifts".

The 20 most important microfinance markets are listed in Figure 3 together with the corresponding IMF forecasts. If the real GDP growth of these countries is calculated using a simple average, this produces a growth rate of 4.8% for 2015, compared to 4.4% for 2014. The outlook for growth in individual markets is also analysed in greater detail in the chapter "Positive outlook, regional shifts".

Figure 3: Forecasts for real GDP growth in responsAbility's 20 most important microfinance markets

Real GDP growth (%)	2014	2015
Peru	3.6%	5.1%
Azerbaijan	4.5%	4.3%
Cambodia	7.2%	7.3%
India	5.6%	6.4%
Georgia	5.0%	5.0%
Ecuador	4.0%	4.0%
Costa Rica	3.6%	3.6%
Armenia	3.2%	3.5%
Kenya	5.3%	6.2%
Kyrgyzstan	4.1%	4.9%
Tajikistan	6.0%	6.0%
Mongolia	9.1%	8.4%
Paraguay	4.0%	4.5%
Kazakhstan	4.6%	4.7%
Russia	0.2%	0.5%
Bolivia	5.2%	5.0%
Turkey	3.0%	3.0%
Bosnia and Herzegovina	0.7%	3.5%
Ghana	4.5%	4.7%
Colombia	4.8%	4.5%
Average	**4.4%**	**4.8%**

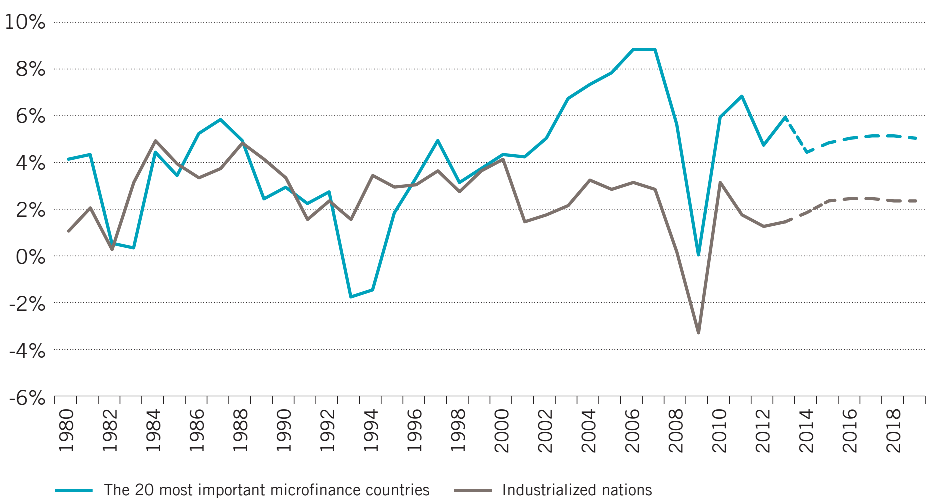
Source: IMF World Economic Outlook Database, October 2014

A closer look at these countries reveals that the vast majority have a disciplined fiscal policy and a relatively independent monetary policy – strengths that are reflected by their comparatively low rates of inflation. The central banks still hold substantial foreign currency reserves and thus have greater flexibility to manage their currencies. In view of their stability, developing economies and emerging markets are attracting record volumes of foreign direct investment according to the UN Conference for Trade and Development (UNCTAD): The annual growth rate over the past four years was 10%. Foreign direct investment also had a positive impact on local development in the areas of infrastructure, salary growth and tax revenues, as well as in other areas of economic life. Viewed overall, favourable conditions are in place to enable the spiral of success to continue in these emerging markets.

Across the target markets, the economic outlook remains favourable: According to current IMF forecasts, wealthy countries will generate real GDP growth of 2.3% in 2015 – thus already achieving the average level expected in the medium term. The IMF suggests that the world's most important microfinance countries will see a slight increase in momentum in the forecast period that runs to 2019, achieving real GDP growth of 5%. Consequently, the difference in growth between these two worlds will tend to widen (see Figure 4). According to the IMF data series, South and East Asia as well as Sub-Saharan Africa will be the main drivers of growth in the medium term.

"Emerging markets can clearly not be lumped together. In terms of their focus on reforms, there are vast differences between them that have a direct impact on the private sector."
Nouriel Roubini, Economist,
in Zurich, 16 October 2014

Figure 4: Real GDP growth



Source: IMF World Economic Outlook Database, October 2014

Microfinance remains attractive even in a rising interest rate environment

Six years after the start of the financial crisis, key interest rates in most developed economies are still close to zero as central banks seek to counter deflationary trends and signs of stagnation. However, this could soon change: The US Federal Reserve already indicated in spring 2013 that it intends to return to a more normal monetary policy. It began taking these steps in early 2014, tapering its bond-buying programme[4]. Despite weak economic growth in the first half of 2014, the US Federal Reserve is expected to announce its first interest rate rise in 2015. Meanwhile, the European Central Bank is continuing to pursue an expansionary monetary policy.

Unlike conventional bonds or bond funds, microfinance investment vehicles such as those at responsAbility are not negatively impacted by a possible rise in interest rates. responsAbility's fixed income funds are not valued at market prices but at cost, minimizing the volatility of fund performance due to changes in interest rates. The interest rate level of the investments, which are predominantly made in US dollars, comprises the corresponding US swap rate plus a credit risk premium. If US interest rates were to rise while the credit risk premium remains unchanged, the refinancing rate for the investments would increase – positively impacting the performance of the funds. Furthermore, the average term to maturity of responsAbility fund investments is relatively short at 20 months. Consequently, there is little delay in adapting them to the prevailing interest rate environment and this occurs without any below-average performance relative to other investments in the long term. It is, however, possible for the credit risk premium to decrease due to a decline in demand (that is actually unwarranted) following a nominal increase in the cost of refinancing. That said, we have succeeded in the past in maintaining it at a relatively constant level. It is therefore to be assumed that the anticipated marginal reduction in the risk premium can be more than offset by the rise in the US swap rate. Microfinance investments remain attractive even in a rising interest rate environment, as the investments are valued at cost and have short maturities. These features offer a degree of protection against price losses in the event of a sharp hike in interest rates.

As monetary policy slowly begins to normalize, however, the markets of developed economies will once again appear more attractive. Clear signs of a future rise in interest rates would be expected to prompt investors to move their assets. Any such reversal of capital flows would also take its toll on emerging markets, which attracted investors with their comparatively high interest rates and more stable environment. Those emerging markets that depend on international financing are likely to be most severely impacted by outflows of assets, as already witnessed in summer 2013[5]. Renewed outflows of capital – especially in the area of portfolio investments – are therefore likely in countries such as Turkey, Brazil or South Africa, which are relatively well integrated into the international financial markets. This trend and the foreseeable strengthening of the US dollar are also likely to adversely impact the currencies of these countries. As stated above, however, many emerging markets are now in a relatively good position to absorb a degree of market volatility. In addition, the foreseeable rise in interest rates will be preceded by a further recovery of the US economy, which will have a positive effect on emerging markets since many of them are strongly dependent on the US as an export partner.

While experience has shown that listed companies and indices tend to be the first to mirror changes in market conditions, the microfinance sector – which is closely connected to the real economy of a country – should only be affected by macroeconomic fluctuations to a limited extent. Although MFIs will have to expect their refinancing costs to increase if the US reference interest rate rises, financing costs are only a secondary factor influencing their overall cost structure – with operating costs being the main determining factor. MFIs will therefore be able to absorb a slight increase in refinancing costs relatively well. Furthermore, strict investment criteria minimize the risk of the MFIs in the responsAbility portfolio experiencing an imbalance in balance sheet terms, should the currency of the country in question depreciate against the US dollar.

While it is to be expected that rising interest rates will have a positive impact on fixed income microfinance investments due to an advantageous fund structure, it can also be assumed that classic microfinance countries will not be strongly impacted by volatility in the international financial markets. Hence, a higher interest rate environment has an effect on the microfinance sector in the form of slightly higher refinancing costs but we still expect to see sustained strong market growth, as explained in the next chapter.

4 Since 1 October 2014, the US Federal Reserve has invested just USD 5 billion in monthly bond purchases, compared to USD 85 billion at the height of its quantitative easing programme.

5 Ben Bernanke, the then Chairman of the US Federal Reserve, raised the possibility of a reduction in bond purchases in a speech he made in May 2013. This created nervousness among investors, provoking a significant outflow of capital from emerging markets. This was ultimately the main reason for the strong depreciation of certain currencies.

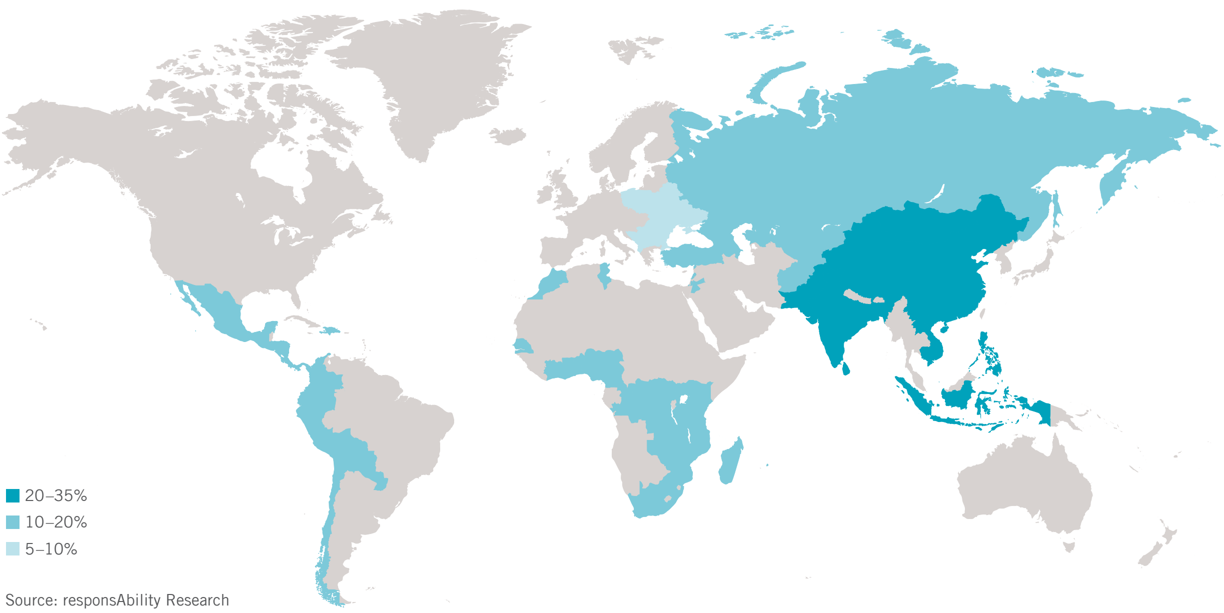
Positive outlook, regional shifts

Like other countries, the emerging markets are subject to economic cycles – and these cycles are duly taken into account in this Microfinance Market Outlook. What is interesting from an investor perspective is that emerging markets are, however, mainly characterized by catch-up growth resulting from decades of pent-up demand. In other words: The growth occurring in these markets is primarily the result of the chronic undersupply of goods and services, which has negatively impacted millions of private households. The financial sector, which should facilitate the flow of financial resources between households and companies and is therefore rightly viewed as key to the functioning of the economy, should be analysed in particular in this context.

The financial sectors of developing economies and emerging markets are generally underdeveloped. Their capacity has often not evolved sufficiently relative to the overall size of the economy: The volume of lending to other sectors of the economy typically amounts to 20-30% of GDP in these countries, compared to 100-200% of GDP in developed economies. As part of the overall economic growth of developing countries, the financial sector is therefore likely to expand at least three times more rapidly than the economy as a whole.

The development of the financial sector also results in the continued integration of financial services providers into the overall economy. From an investor perspective, greater attention needs to be focused on the macroeconomic environment as this development process advances. Providers of equity capital participate directly in both positive and negative changes in the economic environment. However, experience has shown that providers of debt capital tend to be well protected against economic volatility, since only extreme events would seriously impair the ability of carefully selected companies to repay their loans. In microfinance markets, debt investments perform better in the medium term because the growing loan portfolios of MFIs can lead to additional refinancing needs in a flourishing environment. From this perspective, it is understandable that providers of debt capital also want to be informed in detail about changes in the market environment.

Figure 5: Growth forecasts for the microfinance sector by region (real annual increase in gross loan portfolio)



Source: responsAbility Research

responsAbility is responding to this need with the latest Microfinance Market Outlook: To provide a more detailed insight into the microfinance environment in key markets, we conducted no fewer than 32 interviews with a wide range of experts. We also examined the current portfolio data gathered each month from around 300 MFIs, from which 100 MFIs are used for our representative model portfolio, that remains unchanged over time. In addition, our overall picture is based on IMF macroeconomic forecasts. Drawing on this broad range of data, we expect the global microfinance sector to achieve growth of 15-20% in 2015 (see Figures 5 and 6).

Figure 6: 2015 forecasts for regional microfinance markets

Region	Forecast portfolio growth in 2015
South America	10-15%
Central America	10-15%
Sub-Saharan Africa	10-20%
Middle East and North Africa (MENA)	15%
Central Asia	10-15%
Eastern Europe	5-10%
Asia-Pacific	30-35%
Total	**15-20%**

Source: responsAbility Research

The individual regions are likely to develop as follows:

Figure 7: South America, GDP forecasts for selected countries

South America	2014	2015
Peru	3.6%	5.1%
Ecuador	4.0%	4.0%
Paraguay	4.0%	4.5%
Bolivia	5.2%	5.0%
Colombia	4.8%	4.5%

Countries in which responsAbility invests
Source: IMF, responsAbility Research

There has been no shortage of negative headlines in recent months about weak economic growth in **South America.** However, these headlines always refer to Brazil's stagnation or to the massive contraction of the economies of Argentina and Venezuela. In stark contrast, large microfinance countries along the Pacific Coast and in the Andes region are continuing to grow. IMF forecasts suggest that Peru and Bolivia will grow by just over 5% in 2015, while the growth rate for Colombia and Paraguay is expected to be 4.5%. Peru has overcome the economic weakness caused by falling metal exports and should be back on track to achieve its growth potential by the end of 2015. Bolivia held elections in October 2014 at which the current leadership – which has been in power since 2006 – was re-elected. Colombia remains the driving force in the region: Investor interest in the country has been bolstered by the prospect of a "peace dividend" resulting from negotiations with FARC rebels.

Based on our expert survey, we expect the microfinance portfolio to grow by 10-15% for these countries. Peru's microfinance market – which is at an advanced stage of development – is currently undergoing consolidation and is likely to expand only slowly again in 2015 following a subdued 2014. The growth rate in Bolivia and Ecuador is higher but regulatory uncertainty is weighing on their microfinance sector; this uncertainty is the result of the introduction of new regulatory frameworks. The outlook in Colombia and Paraguay remains positive, provided there is no serious unrest in the neighbouring countries of Venezuela and Argentina.

Figure 8: Central America, GDP forecasts for selected countries

Central America	2014	2015
Costa Rica	3.6%	3.6%
Mexico	2.4%	3.5%
Nicaragua	4.0%	4.0%
El Salvador	1.7%	1.8%
Honduras	3.0%	3.1%

Countries in which responsAbility invests
Source: IMF, responsAbility Research

The economies of **Central America** that are strongly focused on the US are experiencing a moderate but continued recovery – reflecting developments in the world's largest economy. According to the IMF, Mexico and Costa Rica are likely to grow by 3.5%, Nicaragua by 4%, Honduras by 3% and El Salvador by almost 2%. In view of its strong dependence on energy supplies as part of the questionable Venezuelan PetroCaribe programme, Nicaragua is being monitored especially closely. Based on this sound economic picture – and because the growth in lending was moderate in recent years – the microfinance markets of Central America are likely to achieve similar growth in 2015 to those in South America.

Figure 9: Sub-Saharan Africa, GDP forecasts for selected countries

Sub-Saharan Africa	2014	2015
Kenya	5.3%	6.2%
Ghana	4.5%	4.7%
Tanzania	7.2%	7.0%
Nigeria	7.0%	7.3%
South Africa	1.4%	2.3%

Countries in which responsAbility invests
Source: IMF, responsAbility Research

The countries in **Sub-Saharan Africa** are continuing their success story. In Kenya, Nigeria, Ghana and, to some extent, also in Tanzania, the private sector has developed enormously from a quantitative and qualitative perspective. These countries are today generating strong domestic demand that is largely driven by private consumption. With the exception of Ghana, all of the larger economies have succeeded in keeping inflation in single digits, resulting in the stabilization of their currencies. Financing conditions have also improved: In a notable development in 2014, Kenya and Ivory Coast were able to access the international capital markets by issuing Eurodollar bonds. According to the IMF, Kenya is likely to grow by over 6% in 2015, while Tanzania and Nigeria may achieve growth of as much as 7%. At 4.7%, Ghana's growth rate remains relatively moderate and is therefore significantly below the average for Africa. The economic impacts of the Ebola virus in West Africa are still difficult to assess. responsAbility does not currently have direct investments in the countries that are affected on a large scale. In view of the urgent demand for capital, it will, however, consider investing there once business returns to normal. With regard to portfolio developments at MFIs, the experts interviewed were more conservative in their forecasts: They expect the major African microfinance markets to achieve growth rates of 10-20% in 2015; this is around 10 percentage points below the level defined for 2014.

Figure 10: Middle East and North Africa (MENA), GDP forecast for selected countries

MENA	2014	2015
Turkey	3.0%	3.0%
Tunisia	2.8%	3.7%
Morocco	3.5%	4.7%
Jordan	3.5%	4.0%
Lebanon	1.8%	2.5%

Countries in which responsAbility invests
Source: IMF, responsAbility Research

Viewed overall, the countries in the **Middle East and North Africa (MENA)** region are continuing their economic recovery despite some political uncertainty. The IMF expects Turkey to achieve growth of 3%, driven by expansionary monetary policy, while Tunisia and Morocco are expected to see a significant acceleration in growth of more than 1 percentage point. Turning to Jordan, the Syria conflict has not yet had any substantial political or security-related impacts on its economy but the continued influx of refugees is placing an increasing burden on the country. The microfinance markets of Tunisia, Morocco and Jordan are likely to grow by around 15% according to the expert survey. This encouraging growth rate is mainly attributable to the improved market infrastructure, adequate regulation and the existence of credit bureaus. In the case of the Tunisian market, it is particularly pleasing to note that it is experiencing an upturn four years on from the Jasmine Revolution. This process has been underpinned by the establishment of a series of MFIs.

Figure 11: Central Asia, GDP forecasts for selected countries

Central Asia	2014	2015
Azerbaijan	4.5%	4.3%
Georgia	5.0%	5.0%
Armenia	3.2%	3.5%
Kyrgyzstan	4.1%	4.9%
Tajikistan	6.0%	6.0%

Countries in which responsAbility invests
Source: IMF, responsAbility Research

The growth path being followed by the economies of **Central Asia** and the **Caucasus** is threatened by the economic crisis in Russia. Even before the start of the conflict with Ukraine and the associated economic sanctions, Russia was suffering from various problems and adverse trends, such as population decline, an arbitrary judicial system, limited investor confidence, inadequate capital expenditure and dependence on income from commodities exports, which have fallen sharply. The IMF has forecast that Russia's economy will stagnate in 2015. Georgia does not have any material economic ties with Russia and is likely to continue growing at 5%. In Armenia and Azerbaijan, however, GDP growth has weakened to 3.5% and 4.3%, respectively. IMF economists expect Tajikistan to grow by 6% and Kyrgyzstan by almost 5%.

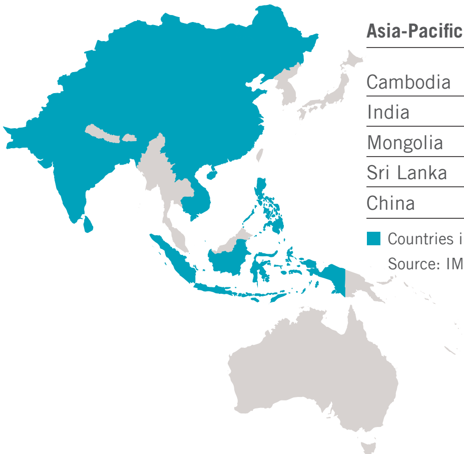
Russia's financial sector has not yet felt the full impacts of the sanctions. Caution is therefore needed, even if the microfinance model has proved remarkably resilient in various crises around the world. For example, states in the former Soviet Union were able to absorb the impacts of Russia's severe 2009 recession relatively well. The first negative effects are now becoming apparent in the field of consumer financing but not in the area of traditional microloans. The SME lending business and the microloans business in Russia are, however, also likely to be impacted in 2015 – with stagnation being the best-case scenario. The experts interviewed for the survey expect the still healthy microfinance markets in the Caucasus and in Central Asia to experience a moderate fall in demand, which is likely to be most pronounced in Armenia, Kyrgyzstan and Tajikistan. One expert pointed, in particular, to the difficult conditions in Russia's struggling labour market and to the large number of migrants returning to Central Asia. This particular trend is likely to result in a significant decline in monthly transfers of funds by migrants back to their home countries. Another expert pointed to signs of a withdrawal by Russian banks from neighbouring markets and to the increased scope this will create for local microfinance banks.

Figure 12: Eastern Europe, GDP forecasts for selected countries

Eastern Europe	2014	2015
Bosnia	0.7%	3.5%
Kosovo	2.7%	3.3%
Moldavia	1.8%	3.5%
Serbia	-0.5%	1.0%
Albania	2.1%	3.3%

Countries in which responsAbility invests
Source: IMF, responsAbility Research

Figure 13: Asia-Pacific, GDP forecasts for selected countries



Asia-Pacific	2014	2015
Cambodia	7.2%	7.3%
India	5.6%	6.4%
Mongolia	9.1%	8.4%
Sri Lanka	7.0%	6.5%
China	7.4%	7.1%

Countries in which responsAbility invests
Source: IMF, responsAbility Research

Eastern Europe is participating in Western Europe's tentative recovery as a result of strong economic ties with the region. The impacts of the Ukraine crisis have so far been very limited. In the case of Bosnia, the IMF is forecasting growth of 3.5% – the strongest expansion of its economy since the beginning of the Euro crisis. One reason for this is the momentum generated by reconstruction measures following the catastrophic floods of spring 2014. A recovery is visible in Kosovo and Serbia, while the economies of Romania and, in particular, Moldavia – which has an exposure to Ukraine – are making very slow progress. The experts interviewed by responsAbility expect the microfinance portfolio to generate single-digit growth again in 2015 due to the moderate quality of the portfolio.

Asia-Pacific is displaying impressive economic momentum. Domestic markets in the region are booming without price stability appearing to be under threat. The labour markets are healthy, the demographic age structure is favourable and financial conditions are extremely robust due to inflows of capital. As a result, direct investment and portfolio investment recently rose to a new record high. In Cambodia, tensions between the government and the opposition have diminished. The IMF has forecast a growth rate of over 7% for Cambodia's economy for the fifth consecutive year. All Asian markets will benefit from China's soft landing – with its economy now on a moderate growth path of 7%. In contrast, the negligent treatment of foreign investors in Mongolia led to increased risks, with the result that its banking sector – which has grown substantially – is now being monitored. In India, a stable government that is not dependent on coalition partners is in power for the first time in 30 years. In terms of India's economy, the very strong level of capital expenditure and the recovery of exports are aspects that should be highlighted in particular. This generally pleasing picture has prompted the IMF to raise its GDP growth forecast for India to 6.4%. In both India and Cambodia, which are by far the most important microfinance markets for investors in this region, the experts interviewed by responsAbility expect portfolio growth to exceed 30% in 2015.

Revival of India’s microfinance market

In 2011, market commentators predicted the end of India’s microfinance market. At the time, the government of the state of Andhra Pradesh was seeking to prohibit the microloans business. Each issue of the Microfinance Market Outlook published since then has included a special report on India. Today, it can be said that the microfinance sector in the Indian subcontinent has emerged from this crisis stronger than before. Our confidence in the Indian market is demonstrated by the fourfold increase in our volume of investments in India since then – from USD 30 million to USD 120 million.

This optimism is mostly due to the radical realignment of India’s financial sector: The Reserve Bank of India (RBI) – which has been headed by the eminent economist Raghuram Rajan since September 2013 – has called on banks to now finally ensure that the 800 million adults living in India can access basic financial services. This initiative by the RBI was prompted by the unsatisfactory findings of an assessment of what has so far been achieved: The efforts of lethargic state-owned banks and the small private financial sector to supply basic financial services to the population were increasingly subject to reprehensible delays.

Interestingly, the policy defined by the RBI requires the expansion of the offering of financial services and consequently greater competition between financial institutions. In this respect, it has opened up the financial sector to new market powers. This is reflected by the fact that in its very first licensing round, the RBI granted a banking license to an MFI.

India’s microfinance sector thus set sail in a new direction. What was still missing was a strong tailwind to help propel it forward. This new impetus was provided by Indian voters in the parliamentary elections of April/May 2014: For the first time in 30 years, the world’s largest democracy elected a stable one-party government that is not dependent on coalition partners and is therefore less susceptible to political coercion. The new government led by Narendra Modi won the election with a programme that focuses on boosting the private sector and on development. Immediately after coming to power, the government clearly stated that it considered the improved provision of financial services to be a core issue on its agenda. Fears that the government and the RBI would collide in their efforts to achieve this were largely dispelled in September 2014 when Arvind Subramanian – a university friend of the RBI Governor Raghuram Rajan – was appointed Chief Economic Advisor to the Indian government.

The efforts of the Indian government and the RBI are also being supported by macroeconomic developments: According to IMF forecasts, India is likely to return to a growth path of over 6% in 2015 following three years of weaker economic growth. Since summer 2014, the interest of foreign investors has suddenly returned. responsAbility funds have been investing in India since 2008 and a local team has been operating in the Indian market from our Mumbai office since 2011.

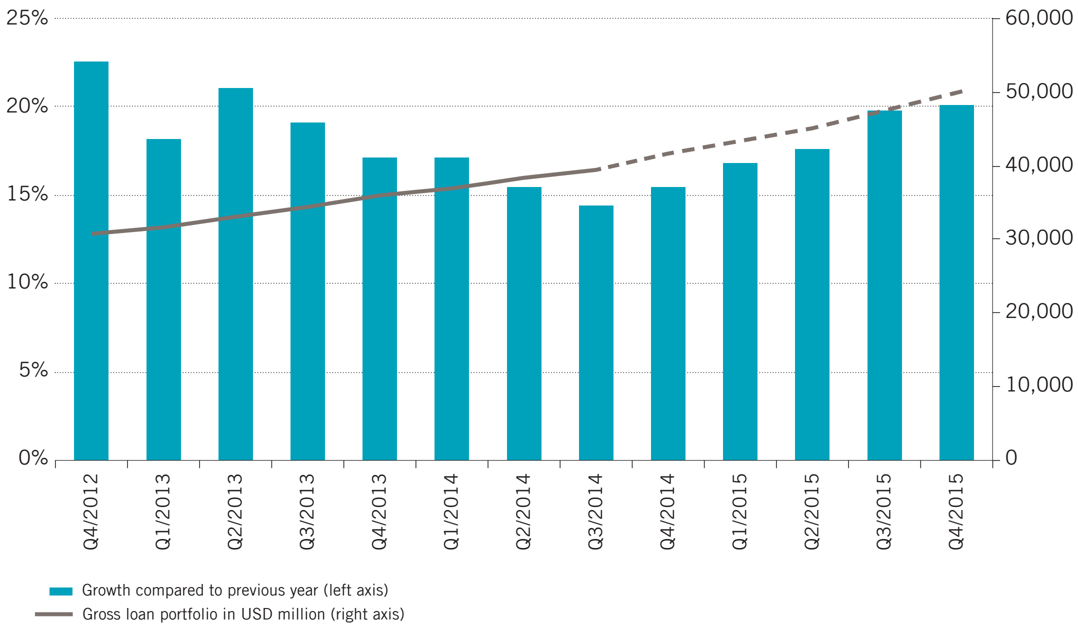
A detailed analysis can be found in our latest Research Insight “The rise, fall and dynamic revival of India’s microfinance market” at www.responsAbility.com.

Expert survey: MFIs look for strong financing partners

responsAbility uses a representative portfolio of 100 key institutions that is unchanged over time to observe the investable microfinance market, as defined at the beginning of this Microfinance Market Outlook. These 100 MFIs are recognized providers in their respective markets and are located across 38 key markets – thus ensuring that they are geographically representative of the microfinance sector. At present, these 100 MFIs collectively have around USD 52 billion of assets under management and serve 25.5 million borrowers. They account for USD 1.2 billion of responsAbility's total investment volume.

Based on this representative portfolio, the microfinance market grew by 15% in the first half of 2014 (see Figure 13). At present, we are seeing an acceleration of the growth rate, which is why we regard the expert forecast of 15-20% portfolio growth for 2015 as a conservative estimate.

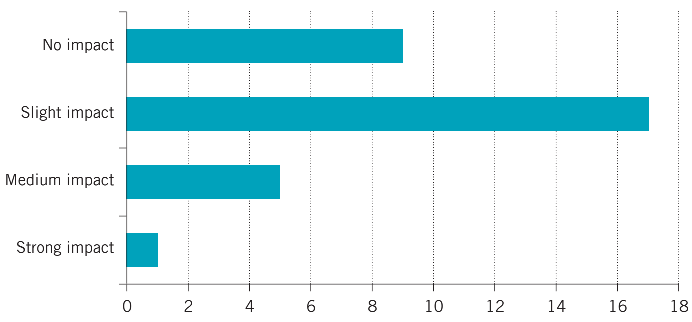
Figure 14: Portfolio growth of the 100 MFIs



Source: responsAbility Research. Figures for Q4 2014 onwards are projections

Decisions by the US Federal Reserve have limited impacts
The experts interviewed for the survey anticipate that the normalization of the US interest rate policy – which is widely expected to begin in 2015 – will have only a limited effect on the microfinance markets (see Figure 15). More than half of the experts interviewed, i.e. 17 participants, suggested that this development will have a slight impact, while a further 9 of these microfinance specialists believe it will have no impact whatsoever. However, five of the experts expect it will lead to medium-level changes and one of the experts suggested that there could even be significant impacts as a direct result of the changing interest rate environment. It is reassuring to note that most of the experts who expect the impacts to be minimal were able to provide a detailed justification for their assessment. Their low level of concern should not therefore be interpreted as a sign that they have too few reliable indicators What is striking about their responses is, for example, that they are keen to highlight the adequate supply of liquidity at present in the markets they observe, while focusing little attention on the risk of a general rise in financing costs as a result of an increase in key interest rates.

Figure 15: Anticipated impacts of an increase in key US interest rates (expert survey)



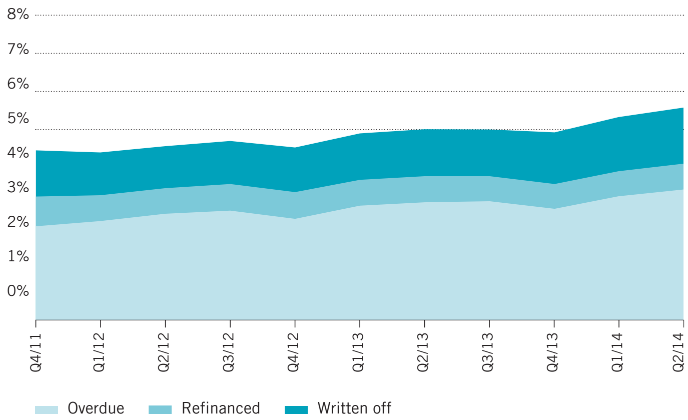
Source: responsAbility Research

Closely monitored portfolio quality
A strict benchmark is applied when determining portfolio quality in the world of microfinance. It separates the loans that are repaid on time by millions of end-clients from loans that are overdue. While bank statistics from wealthy countries only show loans as non-performing after 90 days, the microfinance sector applies much stricter rules based on a period of 30 days. Refinanced loans and write-offs are additionally taken into account, ensuring that all potentially problematic loans are recorded. As of mid-2014, 94.4% of loans were repaid on time. However, a negative trend was visible: Compared to the previous year, the proportion of non-performing rose from 3.1% to 3.4%. While refinancing stagnated at 0.7%, write-offs rose from 1.24% to 1.48% on an annualized basis.

The deterioration in portfolio quality was partly due to the temporary slowdown in growth in Peru, which had a noticeable impact due to the fierce competition in Peru's microfinance market. Another reason was the dent in growth in India, which was particularly visible in the area of microloans for hauliers; the increase in credit risk is a direct consequence of the falling prices for second-hand trucks. In both markets, a significant improvement is to be expected in 2015 according to our expert survey. Portfolio quality is likely to decline in markets affected by Russia's economic crisis: This assessment applies primarily to Ukraine, Belarus, Armenia, Tajikistan and Kyrgyzstan. Overall, portfolio quality in these countries will nevertheless remain above the global average.

Of the 32 experts interviewed, 17 expect portfolio quality to remain unchanged in their markets, while 11 believe it will deteriorate and only 4 expect it to improve. This deterioration is not considered alarming in any individual case. Instead, it is viewed as a gradual trend that is often the result of mounting competition between MFIs. The experts believe that closer monitoring and stricter risk management are needed in response to this trend.

Figure 16: Portfolio quality of the 100 MFIs

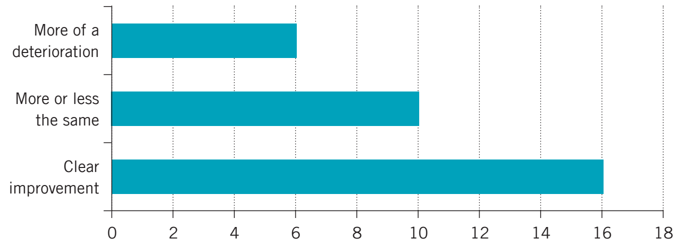


Source: responsAbility Research

Continued improvement in the institutional environment

The operating environment for MFIs is improving according to the experts interviewed for the survey. Half of the experts have observed a significant improvement – contradicting frequent suggestions that there is a backlog of reforms in developing economies and emerging markets. Almost one-third of the experts believe that the level of improvements and setbacks is balanced in their respective markets; just under one-fifth believe there is an overall deterioration in conditions. All of the experts view regulation as the pivotal issue: The general assessment is that central banks and bank regulators are displaying a greater understanding of the microfinance sector. They expressed lower levels of confidence in politicians, whose tendency towards short-term populism all too often eclipses their understanding of development policy. A deterioration of conditions was identified in individual markets in South America and Central Asia. This mainly takes the form of regulatory and state intervention, such as the introduction of interest rate caps, state-imposed lending quotas for certain sectors of the economy, and capital regulations.

Figure 17: Assessment of the institutional environment (expert survey)



Source: responsAbility Research

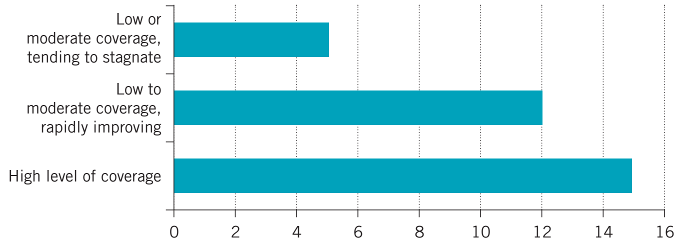
Credit information bureaus: Cost reductions needed

Credit information bureaus are firmly established as an important part of the market infrastructure in most countries. They reduce the risks associated with lending. Credit information bureaus assess the creditworthiness of borrowers by gathering information from other lenders. As a result, households require less physical collateral when seeking to obtain a loan, and households without a bank account can still obtain a credit rating. In addition, the fact that all of the loans held by a borrower are reported reduces the risk of an individual becoming overindebted. Around 100 credit information bureaus currently operate in our target markets. In the survey, almost half of the experts described the level of market coverage by credit information bureaus in their respective market as high. A further 12 experts described the level of coverage as low to moderate but rapidly increasing. Five experts considered the level of coverage to be low, with little progress being made. The fact that several major market participants – typically traditional banks – are not supporting the exchange of credit information was mentioned repeatedly.

> "Credit information bureaus work extremely well. Two private companies and the regulator gather data in order to reduce the risk of overindebtedness. Following painful experiences in the past, the exchange of information is now a highly accepted practice within the industry."
>
> Kurt Koenigsfest, BancoSol

The greatest obstacle standing in the way of improved coverage is said to be the costs associated with credit information services. However, these costs could be reduced through the use of appropriate technologies and through competition between a number of providers. Furthermore, although the costs are clearly visible, the benefits – in the form of substantially lower default rates at MFIs – are hidden, thus exaggerating the problem of costs.

Figure 18: Market coverage by credit information bureaus (expert survey)



Source: responsAbility Research

Continued demand for specialized financing partners in the future

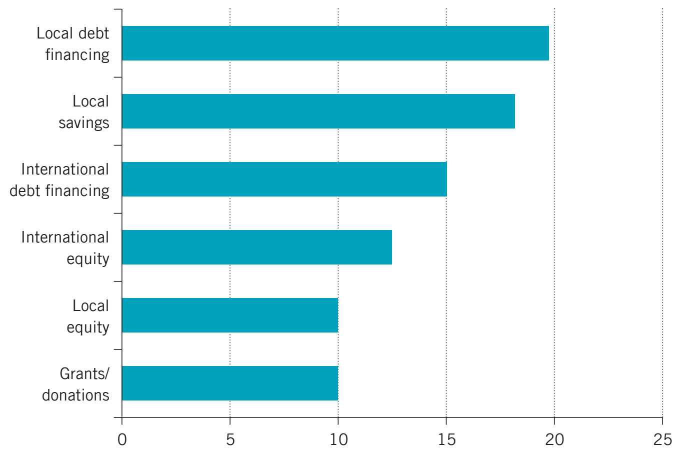
The importance of local financing is continuing to grow in developing economies and emerging markets: Almost two-thirds of the experts stated that the role of savings and loans from local banks is set to increase further in the microfinance markets. Around half of the experts believe that the importance of international debt financing is continuing to grow. Almost one-third of them referred to equity capital from international and local sources (see page 19: "Direct participation: Private equity in the microfinance business"). Meanwhile, not one of the 32 experts has seen an increase in the significance of donations and non-repayable loans.

The trend towards an increase in savings in the balance sheets of MFIs is well documented. The 100 MFIs in our reference portfolio have grown their volume of deposits by almost 30% to a total of USD 29.2 billion over the last two years. This is evidence that the development of the financial sector in various emerging markets is bearing fruit. Secure savings options are very important for low-income households.

"The deposits business will have an important role to play in the long term. However, the level of local savings is still much too low and unstable at present. Reliable international partners will therefore remain indispensable in the coming years."
Senacheert Sim, CEO, PRASAC

However, providers that are active in the deposits business have to comply with strict regulatory requirements. Strong MFIs are now capable of overcoming these significant hurdles. What still sounded like an illusion in India until very recently is set to become a reality in 2015: An Indian MFI will be able to offer savings products for the first time. In this respect, it is not surprising that the other half of our experts believe that if anything, the importance of international refinancing for MFIs is tending to decline. At the same time, only 15% of the experts interviewed believe that these international capital flows will decrease in absolute figures. In summary, there are plenty of indications that MFIs are now increasingly able to tap local sources of financing – which makes sense – but they are still reliant on proven international partners in order to diversify their balance sheets.

Figure 19: Increase in the importance of financing sources (expert survey)



Source: responsAbility Research

Direct participation: Private equity in the microfinance business

The growth in the volume of equity invested in the microfinance business globally will once again exceed the growth in the volume of debt capital in 2015. Our Equity team expects to see a 30% increase in equity transactions, corresponding to the average for the last three years. The Asia-Pacific region is likely to be the main contributor to this growth.

In the area of primary transactions, several large transregional holding companies and established microfinance banks are raising significant volumes of new capital. As the microfinance market develops increasingly, we are seeing a rise in the number of secondary transactions with mature MFIs and also SME banks. This trend will become more pronounced in the coming years, since a series of closed-end funds launched before the financial crisis are now nearing maturity. According to surveys conducted by market observers Luminis and Microrate, at least eight equity or hybrid funds with equity investments of close to USD 600 million will reach maturity between 2014 and 2016 and will therefore need to find buyers for their positions. The geographical realignment of transregional holding companies will lead to further acquisition opportunities.

Capital raising by larger holding companies and the increase in secondary transactions in more mature institutions is leading to larger transaction sizes. The majority of microfinance investors are unlikely to invest more than USD 10 million in a single institution, resulting in an increase in the number of club deals. This trend opens up attractive investment opportunities for recently established funds that are focusing on more mature MFIs and are therefore also better placed to meet the needs of these institutions.

Information concerning the valuations of such equity transactions is, of course, confidential and is rarely made public. However, recent studies contain a series of regional benchmark multiples. We are continuing to see the highest valuations – with multiples of more than 1.5 times book value – in Latin America and Asia-Pacific, and increasingly also in Africa (see Figure 20). Growing transaction volumes and increasing multiples have, in particular, been observed recently in the Indian microfinance market, which has achieved an impressive recovery following the crisis. Transactions in countries in Central Asia and the Caucasus tend to have a significantly lower valuation relative to book value. In Eastern Europe, the number of equity transactions is very limited and they are carried out at or below book value.

Figure 20: Valuation of equity transactions

Latin America	1.5x book value and higher
South and South East Asia	1.5x book value and higher
Africa	1.5x book value and higher
Central Asia and the Caucasus	At book value or slightly higher, with several outliers that are higher
Eastern Europe	At book value or lower

In the microfinance sector, responsAbility wants to participate in the increasingly dynamic equity capital market and has therefore significantly strengthened its Equity team: Operating out of Zurich, Lima and Bangkok, its expanded team is very well positioned to analyse and oversee attractive investment opportunities in more mature market such as Colombia, Bolivia, Cambodia or Kenya. It is in these markets in particular that growth financing and acquisition financing is becoming available to larger market participants that exceed the capacity of many conventional equity funds in the field of microfinance. There is also a growing level of interest on the part of local SME banks. In addition to established market participants, less mature MFIs are continuing to offer attractive investment opportunities – especially in Africa and South Asia. Investments in MFIs that are currently in the process of becoming regulated commercial banks are particularly attractive.

About responsAbility

responsAbility Investments AG is one of the world's leading independent asset managers specializing in development-related sectors of emerging economies. They comprise the areas of finance, agriculture, energy, healthcare and education. responsAbility provides debt and equity financing to non-listed companies with business models that target the lower-income section of the population and can thus drive economic growth and social progress. responsAbility offers professionally-managed investment solutions to both institutional and private investors.

Founded in 2003, responsAbility currently has USD 2.4 billion of assets under management, which are invested in over 500 companies in more than 90 countries. responsAbility is headquartered in Zurich and has local offices in Paris, Lima, Mumbai and Nairobi. Its shareholders include a broad range of reputable institutions in the Swiss financial market as well as its own employees. responsAbility is regulated by FINMA.

As one of the world's largest microfinance investors, responsAbility has invested or reinvested a total of USD 882 million in microfinance companies over the past 12 months,[6] corresponding to an increase of 26.8% compared to the previous year. The volume of assets invested in microfinance markets has now reached USD 1.85 billion, distributed across 77 countries. This significant growth has been achieved as a result of a strong and slightly increased presence across different continents. Factors that contributed to this successful expansion include active portfolio management and the efficiency of its joint investment process.

About the author:

Christian Etzensperger is a Senior Research Analyst at responsAbility Investments. He holds an MA in Economics and an MSc (Distinction) in Economic Development from the University of Glasgow Adam Smith Business School. He is also a Chartered Alternative Investment Analyst. Before joining responsAbility Investments in 2010, Christian Etzensperger worked as a quantitative analyst at Bank Vontobel and as a macroeconomist and industry analyst at Credit Suisse.

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The Microfinance Market Outlook 2015 is also discussed by its author in an interview that can be found at www.responsAbility.com/multimedia/en together with all responsAbility research studies, publications and webcasts.

6 Third quarter of 2013 to third quarter of 2014.

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