

Morgan Stanley

Global Microfinance Investment Congress

The Evolving Landscape

January, 2008

Ian Callaghan
Head of Microfinance Institutions Group, Morgan Stanley
Tel: +44 20 7677-5154
Mob: +44 77698-82117
Ian.Callaghan@morganstanley.com

Agenda

1. Morgan Stanley and Microfinance
2. Market Issues

Morgan Stanley

1. Morgan Stanley and Microfinance

Morgan Stanley Engagement in Microfinance

- Morgan Stanley is a market leader among investment banks in the provision of international capital market solutions to the microfinance sector
- It has recently established a dedicated 12 member strong microfinance team, the Microfinance Institutions Group (MFIG), which brings to bear Morgan Stanley 's local and market expertise globally
- As well as providing investment banking services to the microfinance sector, the MFIG team will be developing a range of debt and equity products for its clients to invest in, and new products for microfinance institutions to distribute
- Creation of the MFIG team builds on the two ground breaking transactions executed by Morgan Stanley with BlueOrchard in 2006-07. These provided some \$210 million of microfinance debt to 35 microfinance institutions in 20 countries and demonstrated that the “top tier” of MFIs provide an attractive opportunity for mainstream investors

Sample Products and Services

Fixed Income

- Senior and subordinated loans
- Asset securitisations
- Foreign exchange - operations and hedging

Equity

- Public and private equity capital raising for MFIs and networks
- Creation and distribution of funds, FoF etc

Advisory

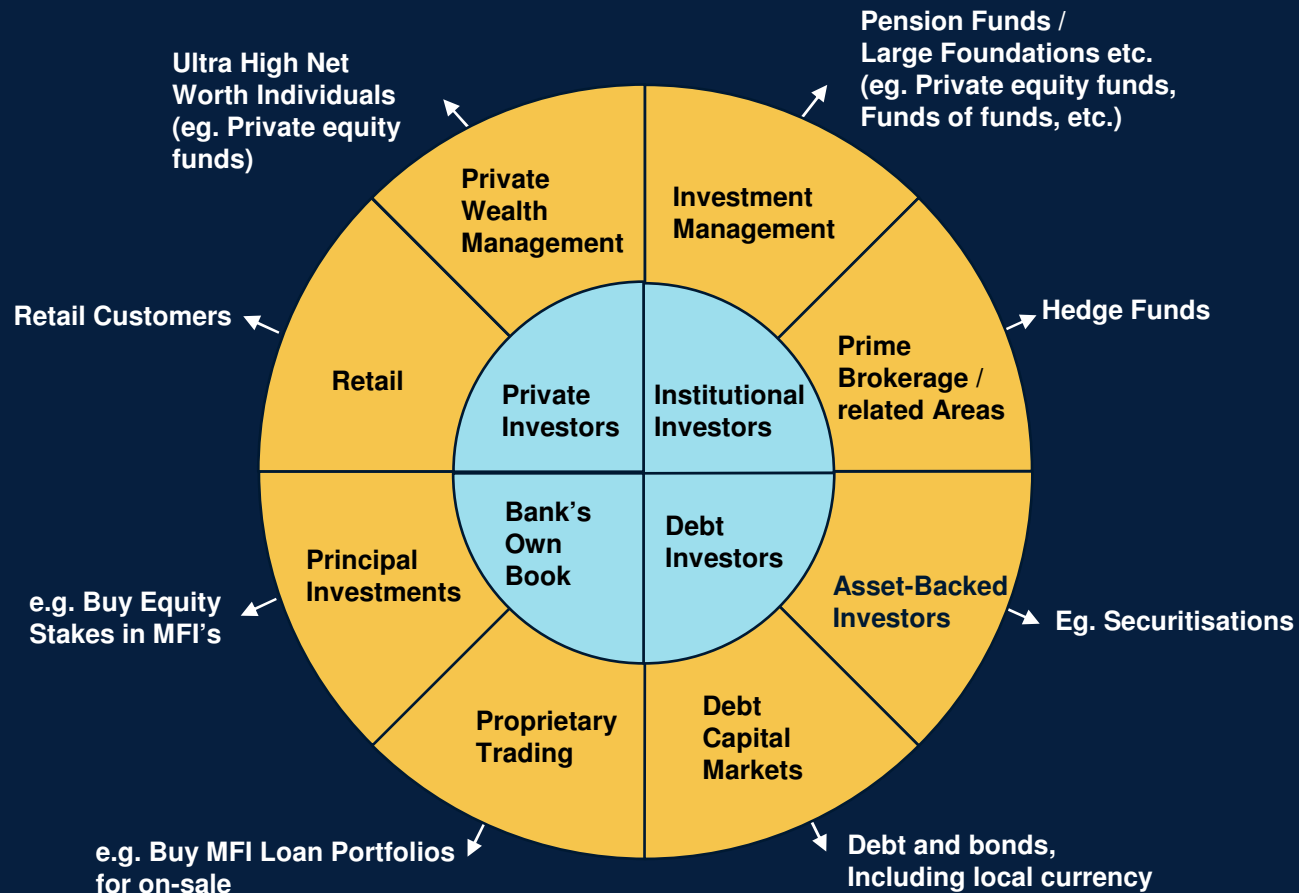
- Mergers & acquisitions
- Corporate finance advice on capital structure

New Product Development

- Clean water
- Distributed energy
- Housing
- Hedging/insurance
- Etc

Potential demand in many investor bases

- Morgan Stanley aims to structure appropriate instruments for the various types of investors that could be interested in microfinance
- These might range from private clients through various kinds of institutional investors to a bank's own portfolio



Morgan Stanley

2. Market issues

Structured Credit - Recent CDO Market Update

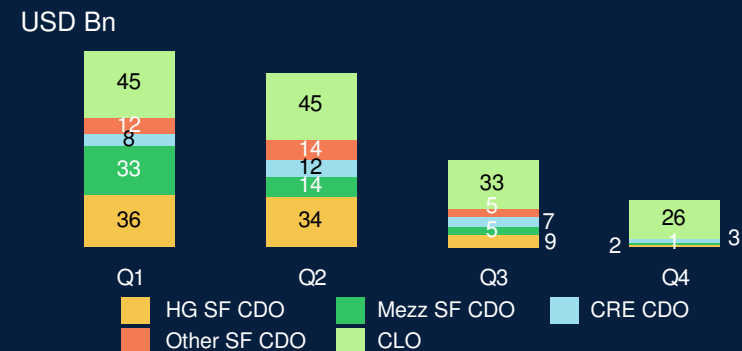
Growth in CDO Issuance



Source: Morgan Stanley

- CDO new issuance fell steeply after several years of growth and was at marginal levels in the last quarter of the year
- CLO spreads continued to widen substantially in both European and US CLOs across the capital structure
- Rating actions in CDOs were largely downgrades
 - However, CLOs continue to demonstrate outstanding ratings performance

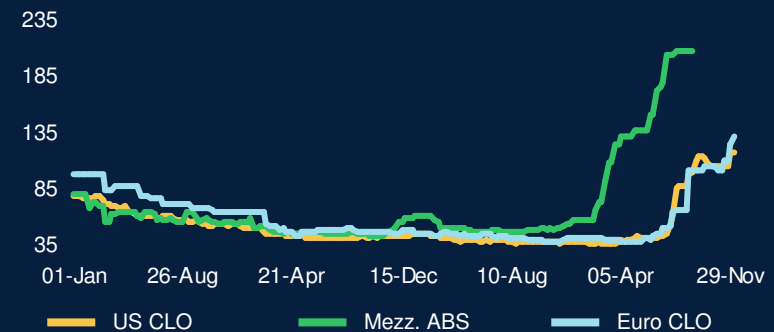
Quarterly CLO / CDO Issuance - 2007



Source: Morgan Stanley

Funding Cost

CLOs and Mezzanine SF CDOs



Source: Morgan Stanley

Equity Issues

- Many positive developments:
 - For-profit startups
 - Increasing transformation of NGOs
 - IPOs and listings of larger MFIs
 - Entry of mainstream / venture investors in size
 - Improved governance
- But significant problems remain :
 - Lack of data
 - Unwillingness / lack of incentives to divest and recycle capital
 - Confusion over “mission” vs commerce
- These factors lead to a severe lack of liquidity which could endanger the health and future growth of the industry

Case Study - Data and Investability

“Top Ten” MFIs

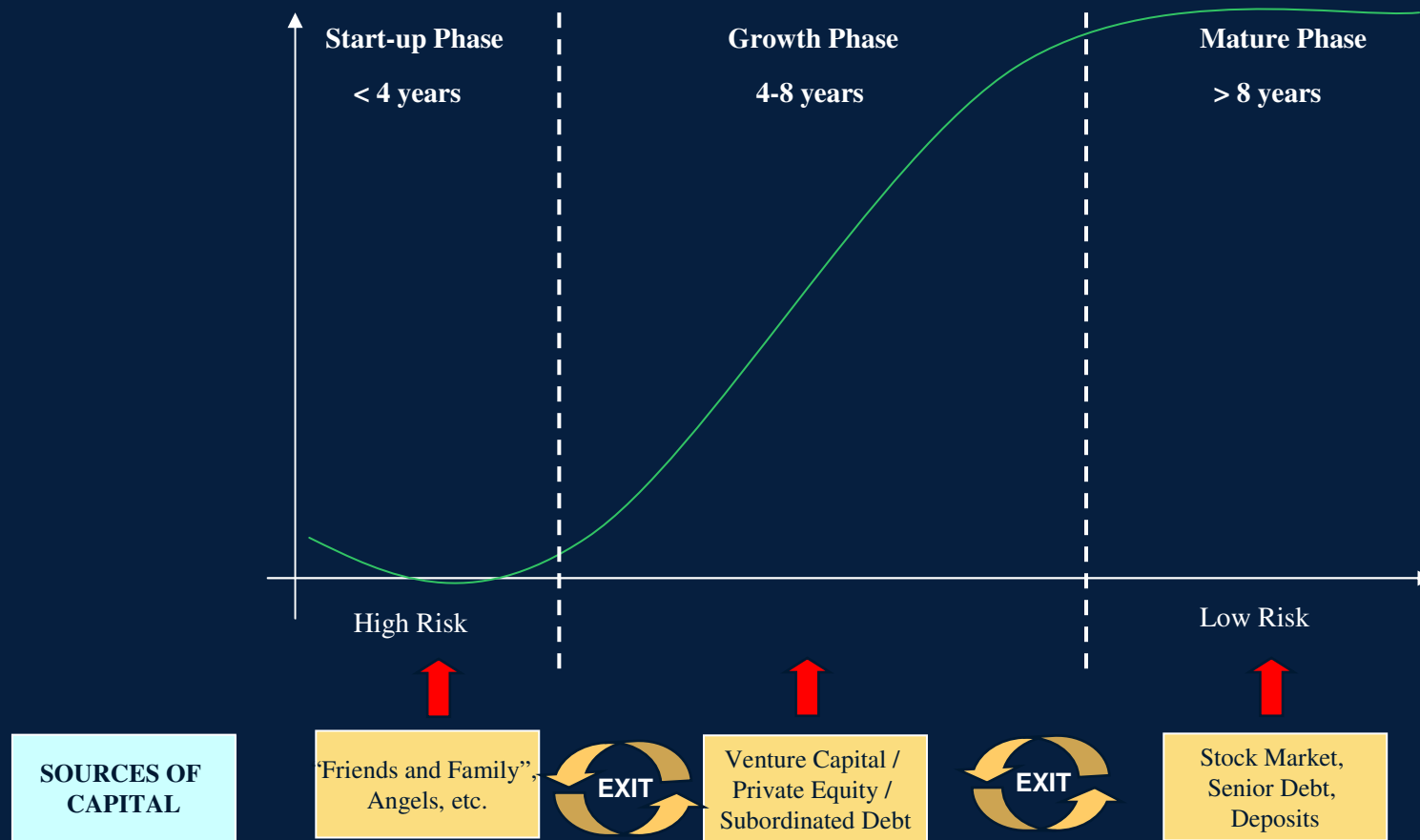
MIX Market’s List of Top 10 MFIs			Forbes’ List of Top 10 MFIs		
Name	Country	Ownership Status	Name	Country	Ownership Status
Zakoura	Morocco	NGO	ASA	Bangladesh	NGO
Sabaragamuwa	Sri Lanka	NBFC	<i>Bandhan</i>	India	NGO transforming into NBFC
<i>Al Amana</i>	Morocco	NGO	Banco do Nordeste	Brazil	90% owned by Brazilian Govt.
Grama Vidiyal	India	NGO transforming into NBFC	Fundación Mundial de la Mujer Bucaramanga	Colombia	NGO
Pro-Credit Bank Serbia	Serbia	Part of private network , main shareholders IFIs	FONDEP Micro-Crédit	Morocco	NGO
<i>Bandhan</i>	India	NGO transforming into NBFC	Amhara Credit & Savings Inst.	Ethiopia	NBFC
Sarvodaya Nano Finance	India	NBFC owned by women SHGs	Compartamos	Mexico	Publicly listed
ESAF	India	NGO transforming into NBFC	<i>Al Amana</i>	Morocco	NGO
Credi Fe	Ecuador	Bank subsidiary	Fundación Mundo Mujer Popayán	Colombia	NGO
JMCC	Jordan	NBFC	Fundación WWB Colombia - Cali	Colombia	NGO

Source: *Forbes, MIX Market*

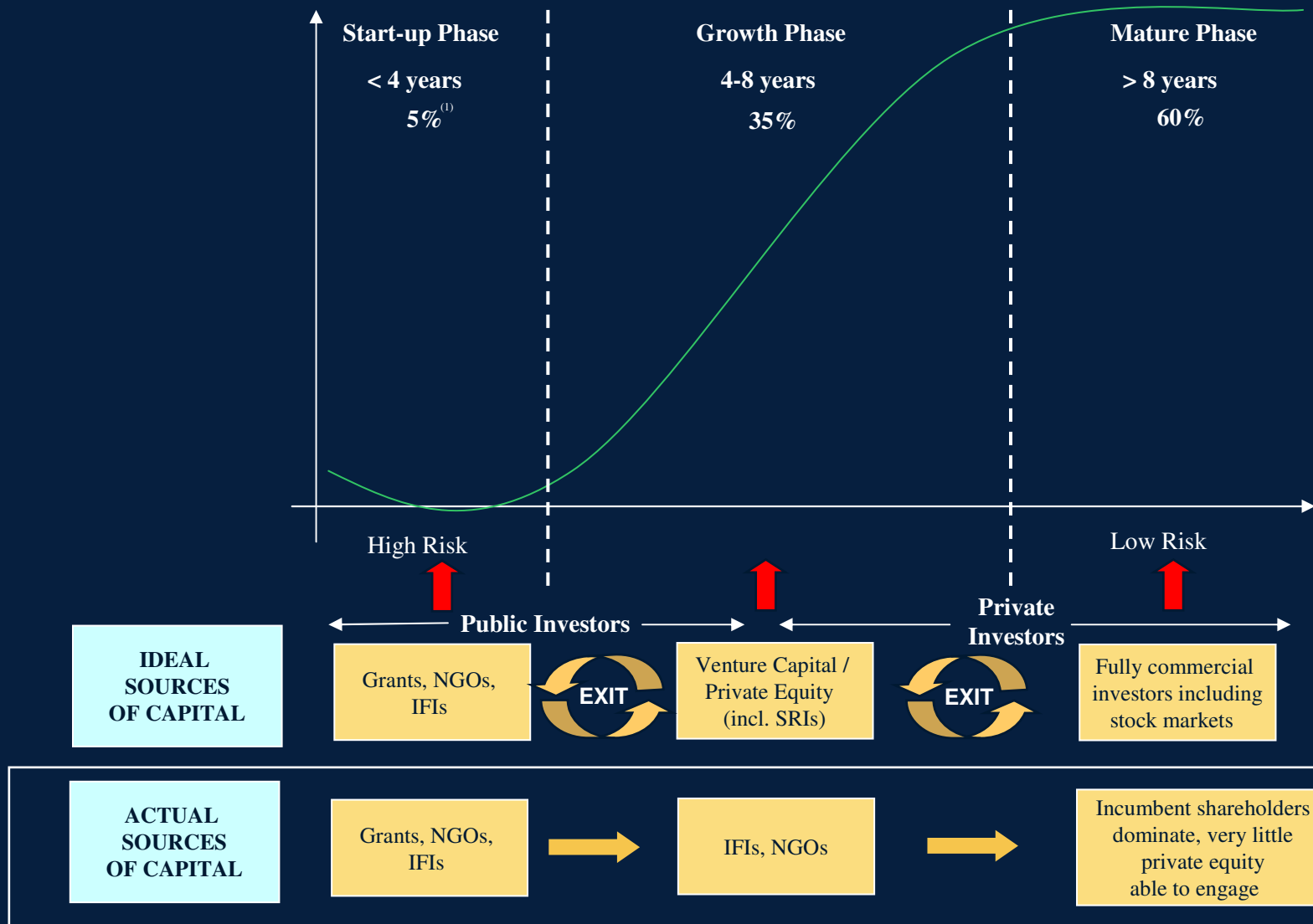
Key Issues

- Forbes Magazine and Mix Market recently published lists of the top 50 MFIs globally
- These lists are derived from exactly the same data, but are completely different because of the different criteria used to rank the MFIs - **there is no clear / standard methodology to evaluate MFIs**
- **Only 2 or 3 MFIs in each “top ten” above are investable**

Case Study – Business Lifecycles – “Standard”



Lifecycle – “Traditional” Microfinance



Case Study – Market inefficiencies

- We can see the effects of lack of market behaviour creating inefficiencies in delivery of microfinance in many countries. Some examples:
 - **Bosnia** has over 50 MFIs servicing a country of about 4 MM people. Over 35 of these MFIs have portfolios of less than \$2.0 MM
 - A CGAP study noted the problem of structural fragmentation in microfinance in **Nicaragua** (with 300 MFIs) undermining the emergence of strong institutions capable of providing a broad range of financial services on a sustainable basis. Operating costs of most types of microfinance providers are not declining due to the excessive number of small inefficient MFIs funded by donors, which do not benefit from the economies of scale needed to reach sustainability
 - In **Peru**, approx. 42 MFIs serve a country with a population of about 28 MM, but according to the IADB, only 30% of micro and small businesses are being adequately served. IADB's report noted that, given lack of scale, the smaller MFIs face problems such as limited product scale, lack of adequate lending technology, lack of comprehensive risk management systems, and weaknesses in corporate governance and capital base; hence, they are unable to compete with bigger banks entering the microfinance space in urban areas

The need for liquidity

- There is currently very limited liquidity in the microfinance equity market, compared to other financial and corporate markets. This is a result of:
 - Unwillingness of founding / incumbent shareholders of MFIs to give up control
 - Lack of management incentivisation via ownership (given the NGO status of many MFIs)
 - Small transaction sizes
 - Poor data and market comparables, leading to difficulties in valuation
 - General market perception that microfinance investments are risky and/or inherently provide concessionary returns
- Such liquidity is, however, vital to the sustained growth of any new market, and its absence from the microfinance sector could lead to a “downward circle” resulting in:
 - A lack of exit opportunities for investors
 - A dearth of information on equity pricing
 - A consequent dearth of information on the performance of microfinance funds
 - Inability of investors with a development mission to recycle their capital to promote the growth of new players in new markets
 - Inability to evolve to meet market demands and create efficiencies of scale

Conclusions

- Microfinance offers an attractive investment opportunity for return, growth and diversification reasons
- These opportunities are, however, constrained by a severe lack of liquidity which makes investment in microfinance more difficult than standard asset classes – even those which are also in a development phase
- Reducing these constraints is vital to the healthy growth of microfinance. In particular, investment opportunities must be improved via:
 - Establishment of standard criteria for evaluation – and valuation – of MFIs
 - Creation of structures and incentives to adapt ownership to market changes and challenges
 - Recycling of capital by specialist early stage investors such as NGO networks and IFIs
 -