

FocusNote

NO. 42

JUNE 2007

CGAP REFLECTIONS ON THE COMPARTAMOS INITIAL PUBLIC OFFERING: A CASE STUDY ON MICROFINANCE INTEREST RATES AND PROFITS



The author of this Focus Note is Richard Rosenberg, CGAP consultant. The author is grateful for help from Andre Laude, Mark Flaming, Martin Holtmann, Kate McKee, Maria Otero, Elisabeth Rhyne, and especially Adrian Gonzalez, Elizabeth Littlefield, and Chuck Waterfield. The views expressed here are those of the CGAP management team, and are not necessarily shared by the outside parties who gave us comments.

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On April 20, 2007, Banco Compartamos, a microfinance institution (MFI) that was launched in 1990 and originally funded by grants from various sources, including CGAP, completed a landmark initial public offering (IPO) of its stock. The IPO was 13 times oversubscribed and considered a huge success by any financial market standard.¹ Pent-up demand caused the share price—representing 30 percent ownership in the bank—to surge 22 percent in the first day of trading. Demand was driven by the exceptional growth and profitability of Compartamos, a dearth of Mexican investments for emerging market portfolios, rarity value, strong management, and the appeal of microfinance.

The spectacular success of the IPO was a milestone not only for Compartamos, but for microfinance. Mainstream international fund managers and other truly commercial investors—not socially responsible investors—bought most of the shares. The transaction will probably give a significant boost to the credibility of microfinance in commercial capital markets and accelerate the mobilization of private capital for the business of providing financial services to poor and low-income people.

Still, the Compartamos offering has raised serious issues for many in the microfinance field and beyond, especially in view of the huge profits it produced for Compartamos shareholders. This Focus Note will address three questions:

- Are Compartamos' exceptional profits, and the high interest rates they are built on, defensible in light of the social bottom line the company identifies as part of its purpose, and are they consistent with the development objectives of its principal shareholders?
- Was the aid money that was granted to Compartamos in its early years used inappropriately to enrich private investors?
- Does the IPO alter the governance of Compartamos in ways that will make it harder for the company to balance social and commercial objectives, especially when there are choices to be made about whether money goes into shareholders' pockets or clients' pockets?

The IPO has occasioned discussion of all these questions. But in fact, the first two questions have little to do with the IPO, because the same issues would be present if the IPO

¹ <http://www.reuters.com/articlePrint?articleId=USN2025193920070420>.



had never occurred. The IPO and the windfall it produced have simply highlighted those issues.

After laying out some history and details of the IPO transaction, we will offer CGAP’s reflections on these questions. The principal sources for our analysis are the offering circular for the IPO and the MIX Market/MicroBanking Bulletin databases.² Because of data issues and simplifying assumptions, some of our calculations may not be fully accurate, but we believe that the likely margin of error is modest enough that the general picture is not materially distorted. We invited Compartamos’ largest shareholders to comment on a draft of this paper.

Historical background and transaction details

Compartamos operated from its inception in 1990 until 2000 as a not-for-profit, nongovernmental organization (NGO). During this period, it received US\$4.3 million in grants or near-grant soft loans from international development agencies and private Mexican sources. The NGO made tiny loans to poor and lower income women, mainly in rural areas.

By 2000, the Compartamos NGO was reaching 60,000 borrowers. To tap commercial funds for even faster growth, the NGO and other investors set up a regulated finance company, organized as a for-profit corporation. Around that time, USAID granted \$2 million to ACCION, a not-for-profit international provider of technical assistance and investment capital to MFIs. With the money, ACCION (1) provided \$200,000 in technical assistance to the Compartamos NGO, (2) gave that NGO \$800,000, which it used to buy stock in the new finance company, and (3) lent \$1 million to the finance company as subordinated debt.³

In addition to grants and near-grants, the for-profit Compartamos finance company received over \$30 million in loans from public development agencies⁴ and \$15 million from private socially oriented

Table 1. A Brief History of Compartamos

1990:	Established as NGO
2000:	Moved operations to regulated for-profit finance company
2002:	Issued debt for first time on Mexican bond market
2006:	Authorized by Mexican government to operate as full-service bank
2007:	Initial Public Offering

investors.⁵ These loans were generally at market interest rates or above.

Beginning in 2002, Compartamos was able to issue roughly \$70 million in bonds on the Mexican securities exchange. Most of these bonds were partially guaranteed by the International Finance Corporation (IFC), which charged a fee of 2.5 percent of amounts guaranteed.⁶ In addition, the company raised about \$65 million by borrowing from Mexican banks and commercial lenders.

In June 2006, the finance company received a full banking license. As a bank, Compartamos is authorized to take deposits, but had not done so up to the point of the IPO in April 2007. The company was serving 616,000 borrowers by the end of 2006 and expects to continue its rapid growth.

The shareholders of Compartamos at the time of the IPO were as follows:

- Compartamos AC (the NGO): 39.2 percent, funded mainly from the CGAP and USAID/ACCION grants
- ACCION Gateway fund: 18.1 percent
- IFC: 10.6 percent
- Directors and managers: 23.7 percent
- Other private Mexican investors: 8.5 percent

² The MIX Market and MicroBanking Bulletin databases are produced by the Microfinance Information Exchange (MIX), www.themix.org. Data on individual MFIs in the MicroBanking Bulletin are confidential and can be used only with the permission of the MFI.

³ ACCION’s Gateway Fund also bought \$1 million worth of shares in the finance company. Compartamos repaid the subordinated loan ahead of schedule when less expensive funding sources became available.

⁴ Inter-American Investment Corporation, KfW (Germany), Andean Development Corporation, IFC, and Instituto de Credito Oficial (Spain).

⁵ Dexia Micro Credit Fund and Credit Suisse Microfinance Fund Management.

⁶ IFC is the private-sector investment arm of the World Bank.

The original price these investors paid for their shares in 1998–2000 totaled roughly \$6 million.⁷ By the end of 2006, the book value of these shares had risen to \$126 million, because of very high profits. The book value of return on shareholders' equity has averaged over 53 percent a year since commercialization in 2000, and over 80 percent of this profit has been retained within the company to fund growth in the number and size of its loans, rather than being paid out in dividends to shareholders.⁸ This retention of high earnings produced the massive growth in the book value of the company.

The profits reflect the high interest rates Compartamos charges on its loans. Compartamos' interest yield on average loan portfolio was about 86 percent for 2005.⁹ (As will be shown later, very high interest rates are common among both for-profit and not-for-profit providers in the low-end Mexican loan market.)

In the April 20, 2007, IPO, shareholders sold about 30 percent of their shares to new investors, most of whom were mainstream international fund managers and other purely commercial investors. This IPO of shares was a secondary offering—that is, Compartamos did not create and sell new shares, which would have brought additional funding into the bank. Rather, proceeds of the sale went to existing shareholders who were capturing capital gains by selling off part of their stake in the bank.

Existing investors received about \$450 million for 30 percent of their shares, which represents more than 12 times the book value of those shares. This implies a market valuation of the company at over \$1.5 billion, and an internal rate of return on the

selling shareholders' original investment (about \$6 million) of roughly 100 percent a year compounded over eight years.

Most of the sale proceeds went to public-purpose institutions—IFC and the ACCION and Compartamos not-for-profit NGOs. A third of the proceeds, about \$150 million, went into the pockets of private shareholders. The unsold shares that remain in the hands of these private shareholders are worth about \$300 million, if valued at the IPO price.¹⁰

1. Are Compartamos' high profits and interest rates defensible in terms of the social bottom line the bank espouses, and are they in line with the development objectives of its principal shareholders?

The most important source of concern about the IPO in the microfinance community has been the huge profits the IPO produced—in particular, the profits for private shareholders. To approach this issue, we need to begin by distinguishing between the *existence* of profits and the *size* of the profits. We see nothing wrong with the fact that shareholders make profits out of Compartamos. Development agencies and private donors have always subsidized some activities that are expected eventually to produce private profits, because they think that a broader social objective will be served at the same time. Building a road or a dam, or funding an export promotion project to generate employment, will all enrich private individuals who are able to build or expand businesses if the project is successful.

From the very early years of Compartamos, all participants, including donors, were clear that the ultimate objective was to fund massive growth in outreach by capturing deposits, and that this would probably require eventual migration of operations into a for-profit corporation. Everyone's long-term vision was a Mexican microcredit market where many private companies were competing to provide financial services to poorer customers, and financing their operations with private commercial sources of funds rather than relying on ever-increasing amounts

⁷ Although the finance company was not licensed until 2000, capital had to be invested earlier to support the license application.

⁸ The MIX Market database (www.mixmarket.org) reports returns as a percentage of average shareholder equity over the course of the year, rather than using initial equity at the beginning of the year. The latter measurement, which arguably gives a better picture of growth over time in the value of shareholders' investment, is even higher. For instance, Compartamos' return on average equity for 2006 was 57.4 percent, while its return on initial equity was over 70 percent.

⁹ Because Compartamos switched to for-profit operations in 2000, interest on its loans is subject to a value-added tax of about 15 percent. In line with Mexican practice, Compartamos deducts value-added taxes when reporting interest income. Thus, the actual interest paid by clients is about 13 percent higher than the rates cited here.

¹⁰ As of June 30, 2007, Compartamos shares were trading at \$6.15, a gain of 66 percent over the IPO price of \$3.70.

of scarce donor funding. It seems clear that Compartamos would not now be serving over 600,000 borrowers, and growing as fast as it is, if it had not taken a commercial approach to its mission. Given the approach that was chosen, no one should be very surprised that private parties are profiting.

The more difficult question has to do with the size of the profits. Even people who favor a commercial approach to most microfinance have to scratch their heads when they see shareholders making annual returns of 100 percent on their investments, compounded for eight years running. To assess whether this is reasonable or ethical in the context of a company and a majority of its investors who have a social objective, one should look at the sources of those profits, and their uses. To what extent do the profits come out of the pockets of poor customers? And are the profits used for further service to more poor people, or do private investors capture them?

As to sources of the profits, the surprisingly high IPO share price¹¹ was driven by a complex variety of factors. It seems likely that the most important of them were as follows:

- *Dearth of competing Mexican securities.* Managers of emerging-market and other international stock funds want to maintain some proportion of Mexican securities for diversification purposes. At the time of the IPO, there were relatively few alternative Mexican issues on offer, which tended to drive up the price at which the Compartamos shareholders could sell their stock. This premium was not associated with any cost to Compartamos' borrowers, so this portion of the profits would seem to pose no conflict with development objectives.
- *Banking license.* At the time of the IPO, Compartamos had its banking license but had not begun to use it to capture deposits. Deposits are a relatively low-cost source of funds. So all other things being equal, pur-

chasers would expect Compartamos to become even more profitable once it starts to take deposits: with no additional investment from the equity owners, the business could expand many times over at the same time as funding costs dropped. The banking license was an intangible asset that cost Compartamos' borrowers nothing. To the extent that the selling shareholders got bigger capital gains because of the banking license, those capital gains would seem to pose no problem from a development perspective.

- *High current profits, driven by high interest rates.* When one looks at the large returns that Compartamos' initial shareholders earned on their investments, it seems probable to us that the largest portion of those returns is attributable to Compartamos' past track record of very high net earnings.¹² Those net earnings were high because Compartamos charged its borrowers interest rates that were considerably above what the company needed to cover its costs, as discussed below. IPO purchasers paid high prices for Compartamos shares, creating huge returns for the selling shareholders, because they expected the pattern of past profits to continue and even grow. Those past profits came directly out of the pockets of Compartamos' poor borrowers, creating a conflict between the welfare of those borrowers and the welfare of Compartamos' investors.

Thus, we would argue that one should not automatically be concerned because the initial Compartamos shareholders made very high returns on their investments. More precisely, the concern should focus on the large portion of those returns that were created by charging higher-than-necessary interest rates to borrowers.

¹¹ As late as December 2006, ACCION was expecting that buyers might pay three times book value for Compartamos shares. Four months later, the buyers of the IPO actually paid 12 times book value.

¹² Investors buy shares in expectation of future profits, based to a great extent on past performance with adjustments for expected future changes. All other things being equal, if Compartamos profits had been two-thirds less (still at a robust level around 20 percent annual return on initial equity), one would expect the IPO shares to have sold for a price two-thirds lower.

A. How high are Compartamos interest rates, and why?

We measure Compartamos interest rates in terms of yield—that is, the actual income collected from borrowers during a year, divided by the average size of the loan portfolio over the year. The interest yield for 2005, according to MicroBanking Bulletin data used with permission, was 86.3 percent. When the value-added tax of about 15 percent of interest is added, the rate paid by clients is about 100 percent. Interest yields in earlier years have been even higher.

These interest rates are considerably higher than those charged by typical MFIs: the worldwide median of MFIs reporting to the MicroBanking Bulletin in 2005 was 30.9 percent. But Compartamos loans are exceptionally small in relation to per capita gross national income—only 5.4 percent in 2005, as compared to a median of 43.5 percent for MFIs worldwide—so its administrative costs are inevitably much higher than average, and its interest rates would therefore have to be higher than average as well.¹³

Of all the MFIs from around the world tracked in the MicroBanking Bulletin, only two peer groups seem relevant as comparators for Compartamos' interest yields: the “low-end target market” group and the “village banking” group. Compartamos interest yields are still high in comparison to these groups (especially when we remember that Compartamos borrowers are paying an additional 13 percent in tax that is not reflected in the reported yield), but on the other hand its relative loan size is much smaller (Table 2).

¹³ Analysts compare loan sizes with per capita national income to shed light on two separate issues: client poverty and administrative costs of lending. The gap between rich and poor in Mexico is very wide, but average income is much higher than in most other countries where microfinance operates. Therefore, the optic of loan size compared to per capita income may tend to make Compartamos' customers look poorer than they are.

However, in this Focus Note, we are using this indicator only to shed light on administrative costs. We use per capita national income when comparing loan sizes and costs because it is our only available proxy—albeit a rough one—for labor costs across countries. Hiring a loan officer costs much more in Mexico than it does in Bangladesh, so the administrative cost associated with processing a \$100 loan will be much higher in Mexico than in Bangladesh. Comparison of MFI costs and efficiency between countries would be grossly distorted without some adjustment to reflect the difference in the cost of labor and other locally produced inputs.

Table 2. Interest Yield and Loan Size: Compartamos vs. Two MBB Peer Groups (2005)

	Avg loan balance as % of per capita GNI	Adjusted Interest Yield (%)
Compartamos	5.4	86.3
Low-end MFIs (median)	16.3	35.4
Village Banking MFIs (median)	23.1	47.2

Source: MBB #14 Trendline Benchmarks (medians).

It is also instructive to compare Compartamos interest rates with those of other Mexican lenders that reach lower income markets. Compartamos is in the upper part of the range, though certainly not at the top (Table 3).

Comparison with other lending rates in the Mexican market is instructive, but most of the loan products are not strictly comparable. For instance, most credit card and consumer lending goes to salaried borrowers, allowing the use of automated credit-scoring techniques. One would normally expect such lending to be less costly than microcredit to unsalaried borrowers, where each loan has to be individually assessed by a loan officer. A more powerful way to analyze the reasons for, and the reasonableness of, Compartamos' interest rates is to examine where this interest income goes (Figure 1).

The largest share of income goes to cover *administrative (operating) costs*. Compartamos' 36.4 percent operating expense ratio might look inefficient in comparison with the 15.0 percent median for MFIs worldwide in 2005. But this measure ignores the impact of Compartamos' loan sizes, which are very small in the Mexican context. A better metric is the operating expense per borrower over the course of a year. Such an analysis provides no suggestion that inefficiency on the part of management is contributing to Compartamos' high interest rates (Table 4).¹⁴

¹⁴ Another meaningful indicator of efficiency is the number of borrowers per MFI employee. In 2005, Compartamos' borrowers/staff ratio was 197, the highest of any Mexican MFI reporting to the MIX and considerably above the medians of the relevant MBB #14 peer groups (all MFIs—127; Latin America/Carribbean MFIs—120; low-end target market MFIs—170; village banking MFIs—158).

Table 3. Mexican Retail Interest Rates

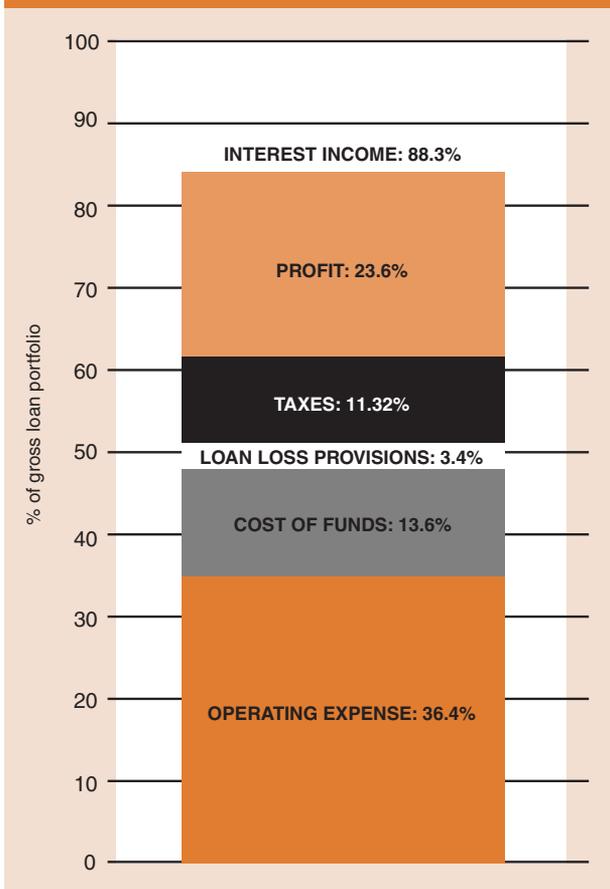
Lender	Interest yield	Year	Source
Compartamos	86%**	2005	MBB database, with permission
MFIs			
FINCA	89 %*,**	2005	MIX Market database
FINCOMUN	103%*,** (?)	2005	“
Caja Popular	23%*,**	2005	“
ProMujer	67%*,**	2005	“
Finsol	81%**	2006	Mexican Banking and Securities Commission (www.cnbv.gob.mx)
Pronegocio	46%**	2006	
Consumer lenders			
Independencia	74%**	2006	Mexican Banking and Securities Commission (www.cnbv.gob.mx)
Familiar	79%**	2006	
Credit cards			
HSBC	75%***	2006	CONDUSEF
Bancomer	59%***	2006	“
Citibank/Banamesx	47%***	2006	“
Inbursa	33%***	2006	“
ScotiaBank	27%***	2006	“
Merchant credit			
Grocery stores	30%/month	2002?	Caskey, Ruiz Duran, and Solo: The Unbanked in Mexico and the United States (World Bank 2004), p. 41
Chain stores (consumer durables)	15%/month	2002?	
Layaway plans	30%/month	2002?	
Other lenders			
Pawnbrokers	27–200%		Communication from J. Armah, CHF
Credit Unions	11–27%		“
Other informal lenders	~4–48% monthly		“

*Yields reported in the MIX Market database are slightly overstated because they include interest income from investments.

**These yields are reported net of value-added taxes, so they understate the cost to the borrower by about 13 percent.

*** Credit card rates reported include the effect of all fees.

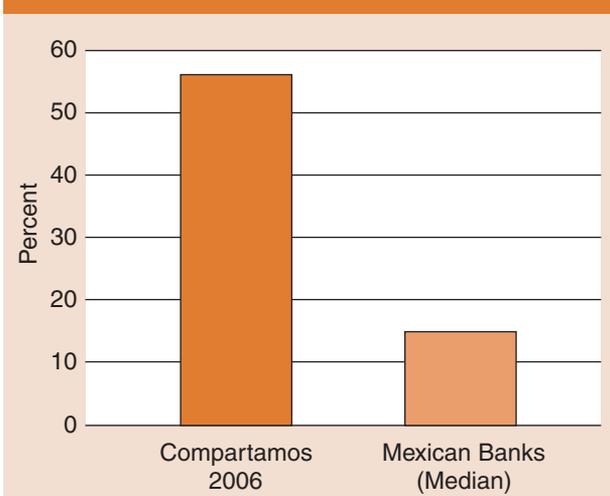
Figure 1. Application of Compartamos Interest Income, 2005



Source: MBB with permission.

Note: The income shown here includes a small amount of interest on investments, and is therefore slightly higher than the 86.3 percent portfolio yield reported elsewhere in the paper.

Figure 2. Return of Average Equity: Compartamos vs. Mexican Banks



Sources: MIX Market; 27 Mexican Banks in BankScope database, excluding Credomatic as an outlier because of its -533 percent ROA.

At 13.6 percent of portfolio, Compartamos' *cost of funds* is a significant contributor to its interest rates. This cost can be expected to decline when the bank starts funding itself with deposits in the near future.

It is apparent that the biggest discretionary driver of Compartamos' interest rate is its high *profit margin*, which is the central issue that needs to be addressed in this discussion.

Figures 2, 3, and 4 present several relevant comparisons. To begin with, Compartamos is extremely profitable compared with Mexican banks. It is also very profitable compared with relevant peer groups of MFIs. Finally, Compartamos profits look high, but are less extreme, in comparison with MFIs and consumer lenders in the Mexican environment.

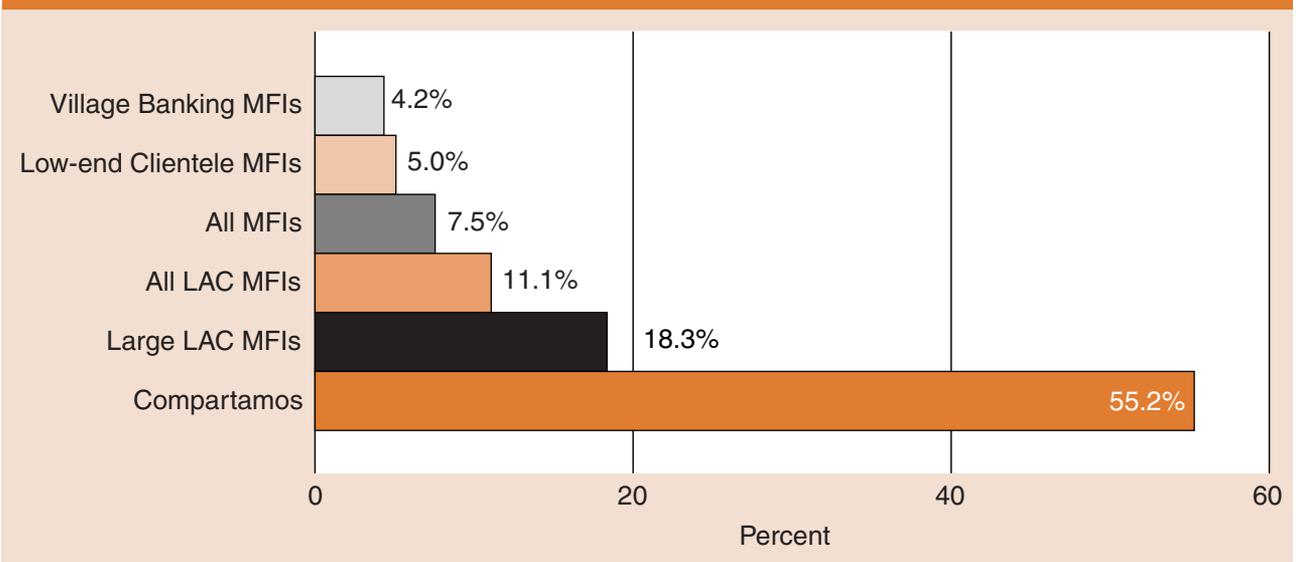
Before moving on to discuss the ethical dimensions of the high profits and interest rates, it is important to be clear about the relationship between the two. It is easy to forget that most of the interest rate is driven by costs, not profits. Figure 5 examines how much Compartamos interest yields could drop if profits were lower and shows that, even in the extreme zero-profit scenario, interest rates would have to remain high by world microfinance standards. If Compartamos reduced its return on average equity to the 15 percent that is normal for Mexican banks, its interest yield would drop by only about one-fifth, from 86 percent to 68 percent.

Table 4. Operating Expense Per Borrower, as Percent of Per Capita GNI (2005)

Compartamos	1.8%
Mexican MFIs	
FINCA	1.8%
FINCOMUN	5.6%
Caja Popular	2.0%
MBB Peer Groups (medians)	
All MFIs	~12%
Latin America/Caribbean MFIs	~10%
Low-end target market MFIs	~37%

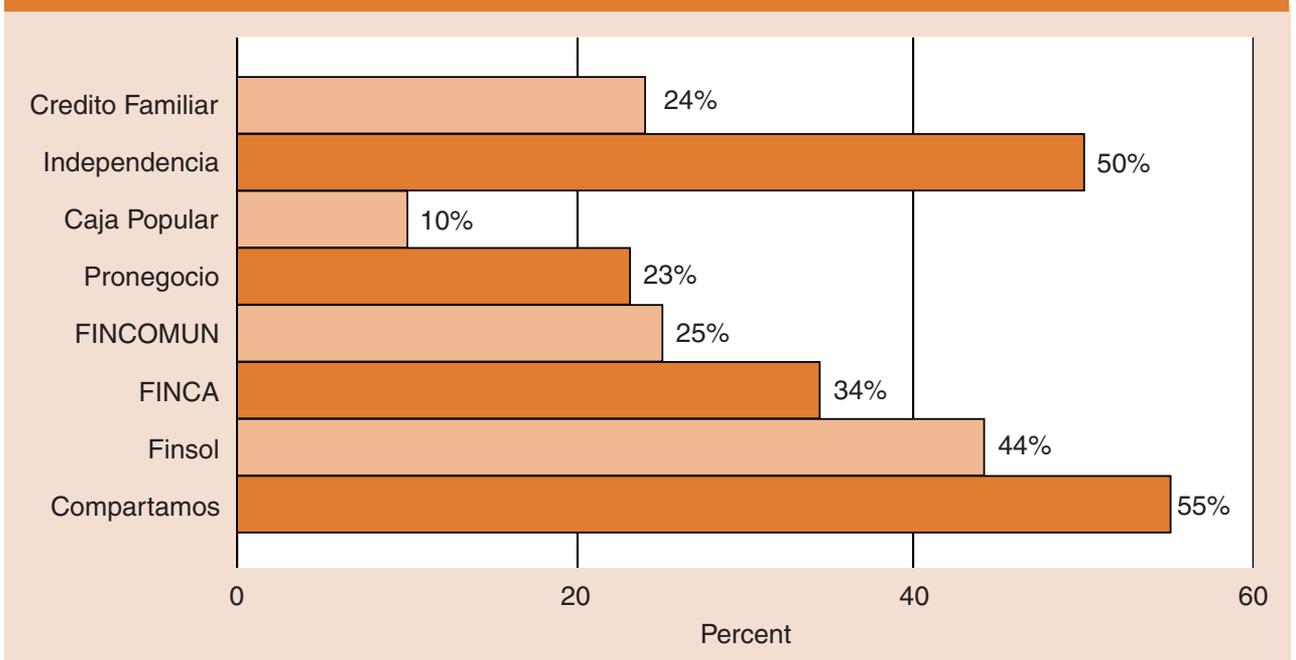
Source: MBB 14 and MIX market.

Figure 3. 2005 Return on Average Equity: Compartamos vs. MicroBanking Bulletin Peer Groups



Source: MIX Market and MicroBanking Bulletin #14 Trendline Benchmarks (medians).

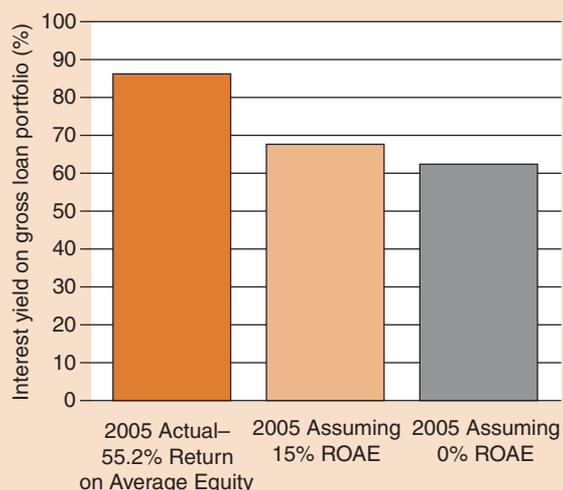
Figure 4. 2006 Return on Average Equity: Compartamos vs. Mexican MFIs and Consumer Lenders



Sources: MIX Market, Mexican Banking and Securities Commission (www.cnbv.gob.mx).

Note: Consumer lenders (top two bars) lend mainly to salaried workers. MFIs (bottom six bars) lend mainly to unsalaried microentrepreneurs.

Figure 5. Impact of Compartamos Profits on Interest Yield



Source: Calculations based on MBB database, with permission.

B. Are the high profits on Compartamos loans consistent with the interests of present and future borrowers?¹⁵

Even after commercialization in 2000, Compartamos has always represented itself (sincerely, we have no doubt) as a business with more than a single “bottom line”—in other words, a business that would try to balance profits for shareholders with a social mission, mainly the welfare of its present and future customers.

When Mexico was hit by heavy devaluation and inflation in 1995, Compartamos, still in a pilot phase of operations, responded by raising its effective annual interest rate above 100 percent, in order to provide real (inflation-adjusted) yields that were sufficient to cover its lending costs. When inflation dropped back to normal levels, the founders and managers deliberated about whether to lower the rates. They had a choice about the matter because they faced little direct competition and were in a near-monopoly position with respect to their clients.

They decided to leave the high charges in place, in order to fund the rapid expansion of outreach to new

¹⁵ As Compartamos starts to use its deposit-taking license, its poor clients will include not just borrowers but also savers, as well as users of payment services and perhaps insurance. We focus on borrowers here because they are the ones directly affected by higher-than-necessary interest rates, which we see as the most important problem under discussion.

Table 5. Compartamos Growth in Outreach

Year	Borrowers	Growth (%)
1996	26,716	
1997	32,254	21
1998	43,401	35
1999	48,835	13
2000	64,141	31
2001	92,773	45
2002	144,991	56
2003	215,267	48
2004	309,637	44
2005	453,131	46
2005	616,528	36
Avg. 1996–2000		24%/year
Avg. 2000–2006		46%/year

Source: Mix Market.

clients. From the very inception of the microcredit program, the leaders of Compartamos stayed focused on their vision of reaching a million poor Mexican women with loans, as quickly as possible. It seems reasonably clear that, in the absence of high retained profits, Compartamos’ expansion from 1995 to 2000 would have been considerably slower. (See Table 5.) The only alternative funding sources would have been more grants or loans from donor agencies. It is unlikely that grants of sufficient size would have been available. Funding assets at the 2000 level with grants would have meant getting donors to donate \$7 million to an operation that had already used \$6 million in startup grants and that was already commercially viable. As to financing growth with loans, Compartamos, as an NGO, could not expect to borrow much from commercial banks, and loans from development-oriented funders were far less available in 1995–2000 than they are now.

It seems to us that as long as Compartamos was an NGO, it was not unreasonable to defend this high-interest-rate, high-retained-earnings strategy in terms of the interests of clients and other poor Mexicans. Basically, it “overcharged” existing clients for the sake of outreach to potential future clients, and all profits accumulated in the NGO would remain at the service of poor Mexicans—some as microfinance clients and others as beneficiaries of

Box 1. Are Loans at 100 Percent Interest Too Expensive to Enhance Borrower Welfare?

Compartamos, like most MFIs, has not done an expensive impact study on borrowers versus nonborrowers to provide a rigorous scientific answer to this question. But there are substantial reasons to think that clients are benefiting.

To begin with, clients themselves obviously judge that the loans are good for them and their households, because they flock to the service in large numbers, often attracted by word of mouth from neighbors who are satisfied clients. Perhaps more important, they repay their loans repeatedly and faithfully, when there are few incentives to do so except a desire to maintain future access to a service the borrowers think is useful to them. Of course, borrower demand does not prove borrower benefit—no one would make this argument in the case of cigarettes, for instance. Not everyone makes wise use of credit. But when lenders are getting significant proportions of their borrowers in trouble, it shows up sooner or later in high delinquency and default levels. This has not happened at Compartamos, any more than it has at well-run microfinance programs that charge lower interest rates.

Some observers worry that the borrowers' microenterprises cannot possibly generate enough returns on invested capital to afford such interest rates. However, tiny cash-starved trading and handicraft microenterprises can often generate very high returns on additional capital.^a It should be noted that if Compartamos is like other MFIs where credible surveys of loan use have been done, then half or more of its borrowers use their loan proceeds for noncommercial purposes, such as buying a television, paying for a child's tuition, or covering medical expenses. As high as Compartamos' interest rate is, it is usually significantly lower than the vendor credit and informal sources that are the clients' main alternatives.

^a E.g., Udry and Anagol (2006) and Cull, McKenzie, and Woodruff (2007).

nonfinancial programs—rather than enriching private investors (Box 1).¹⁶

Once Compartamos commercialized its operations by forming a for-profit corporation in 2000, its average annual growth almost doubled, which was good for its target clientele. But at that point, the trade-off between public and private benefits changed, because private shareholders entered the picture.

Up until 2004, all earnings were retained to fund expanded outreach and potentially other social programs. Since then, dividends to shareholders have been modest—about one quarter of earnings in 2006. But the IPO demonstrates dramatically that shareholders, including private commercial shareholders, don't need dividends to capture profits from the company. As soon as there is a market for the company's shares, shareholders can take out their profits by selling their holdings.

In this circumstance, higher charges to borrowers correlate directly with higher profits captured by investors, including private investors. To that extent, there is a direct and obvious conflict between the welfare of clients and the welfare of investors.

¹⁶ Some may be troubled by taking money from current clients to help future clients. But any initially subsidized MFI is doing this when it decides to charge an interest rate that will make it sustainable in the long term: existing clients are denied the benefit of a subsidized rate, for the sake of creating a business that can reach lots of other clients.

It is instructive to analyze the situation by looking at the funding sources for Compartamos' assets at the end of 2006, just before the IPO (Figure 6). The sources can be broken out among the following:

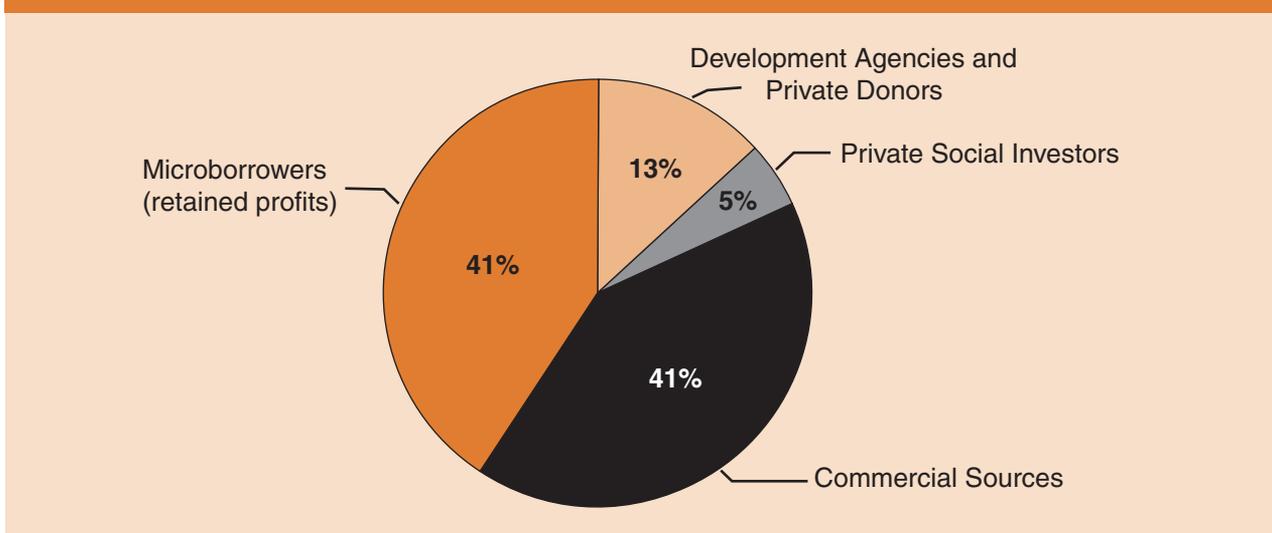
- Development agencies and private donors (grants and quasi-commercial loans)
- Private social investors (quasi-commercial loans)
- Commercial sources (commercial bank loans and individual share purchases)
- Compartamos' microborrowers (retained net profits generated by their interest payments)

This perspective implies that clients have funded a very large part of the current business.¹⁷ Of course, this source of capital will not get any financial return on its "investment."

ACCION's announcement of the IPO on its Web site argues that "[i]t is worth remembering that the income from the public offering comes neither from Compartamos nor, more critically, its low-income clients, but from the domestic and international

¹⁷ If one were to assume that Compartamos takes enough deposits over the next four years to leverage its equity capital to the same degree as a typical Mexican bank, that non-deposit liabilities stay the same, and that return on average equity is lowered to 20 percent, then by 2010 the borrower-financed share of Compartamos assets would be much smaller: donors/development agencies, 2 percent; private social investors, 1 percent; commercial sources (including deposits), 80 percent; and microborrowers (retained profits), 17 percent.

Figure 6. Sources of Compartamos Assets, December 31, 2006



Source: CGAP analysis of Offering Circular data.

financial markets.”¹⁸ This is true, but it fails to address the fact that the income (to shareholders, not to Compartamos) was extremely high precisely because unusually high interest charges to low-income clients produced unusually high profits.

Could Compartamos have reduced its interest rates and profits? One way to do that would be simply to have grown more slowly. True, rapid growth brought commercial advantages. At a minimum, it built market share and occupied the most attractive branch locations and gained the best customers before competitors could move in. But it also brought a clear benefit to poor potential clients who did not have to wait years to get access to a valuable service. *It seems to us that Compartamos’ decision to grow fast has been defensible from a development perspective—which is to say, the perspective of present and future clients.*

But that brings us to the critical question: How should that growth have been funded? Compartamos and its shareholders say that unusually high profits were a necessary part of the equation: “[t]he returns received have become retained earnings and allowed the institution to nearly double its reach over the last three years, *something it could not have done any other way.*”¹⁹

¹⁸ http://accion.org/media_noteworthy.asp_Q_N_E_344

We have not been privy to Compartamos’ financing alternatives and decisions, but that statement is far from self-evident for us, at least when applied to the period after Compartamos commercialized. The years since 2000 have seen what can only be described as a flood of new publicly owned or socially motivated investors—“international financial institutions” (IFIs) and “microfinance investment vehicles” (MIVs)—who are anxious to invest large amounts in debt and equity of MFIs.²⁰ The supply of such funds has been, so far at least, larger than the demand from high-quality MFIs who meet these investors’ risk and return criteria. The result is that many of the IFIs and MIVs have been competing for, and concentrating quite a bit of their investment in, a relatively small number of top-grade MFIs like Compartamos. We have little doubt that Compartamos has turned down expressions of interest from a number of these investors since 2000, and even less doubt that it could have raised more MIV funds if it had actively pursued them.

Compartamos has been justifiably proud of its strong corporate and bond ratings from rating agencies like Fitch and Standard & Poor. Taking on more debt in relation to the company’s equity base inher-

¹⁹ Ibid, italics added.

²⁰ See Ivatury and Abrams (2005) and Reille and Sananikone (2007).

ently raises the riskiness of any company. If Compartamos had borrowed more to fund its expansion, the effect might perhaps have been to lower its ratings and increase its overall cost of funds. On the other hand, the company was not heavily leveraged—its 2006 debt-to-equity ratio was only 1.35—so there was probably room for at least some additional borrowing without hurting Compartamos’ ratings.

At any rate, Compartamos may have faced a trade-off between paying a few more percentage points on its borrowings on the one hand, and lowering the interest rates charged to its clients on the other. Might not a business with a strong and effective social motivation choose the latter?

But more to the point, why couldn’t Compartamos have taken equity investments from the IFIs or MIVs, which would allow it to expand its funding—including borrowing more—without hurting its debt-to-equity ratio? Issuing new shares to MIV investors may not have been good for the existing investors whose shareholding would thereby be diluted: the MIVs would probably not have paid the 1,150 percent premium over book value that the IPO produced. But was a lower financial return for existing investors weighed against the benefit to clients in the form of a lower interest rate?

We do not want to imply that the decision not to take in more equity from social investors was driven solely, or perhaps even mainly, by maximization of shareholder profits. Compartamos had a preference for truly commercial investors (the kind that bought shares during the IPO) because it wanted the Mexican financial sector to see microfinance as real banking, not the preserve of socially motivated, not-really-hard-headed, investors. It believed that truly commercial investment was the best path to reaching massive numbers of clients. Also, bringing in new social investors with large blocks of shares would have diluted the original shareholders’ control of operations, whereas the shares sold in the IPO went to a wider number of investors who are less likely to organize in opposition to the original shareholders. But these considerations, as well, had to be weighed against the consequences for clients of funding growth through high interest rates and high retained earnings.

As noted, we do not have access to detailed information about the financial circumstances and decisions faced by Compartamos and its shareholders from 2000 to 2006, nor are we privy to their motives for their choices. But looking at the facts available to us, *it is hard to avoid serious questions about whether Compartamos’ interest rate policy and funding decisions gave appropriate weight to its clients’ interests when they conflicted with the financial and other interests of the shareholders.* It is not clear how much Compartamos’ decisions on those issues differed from what one would expect from a purely and forthrightly profit-maximizing company and its investors.

One needs to be realistic about commercialization of microfinance. Although it brings the advantage of access to much greater funding and allows exponential expansion in the number of people served, one cannot be too shocked if a for-profit corporation starts acting like other businesses.²¹ But in the Compartamos case, a controlling majority—two-thirds of the shares—was held by three pro-bono shareholders who were committed to development objectives, not profits. At a minimum, one wants to ask why they did not insist that greater weight be given to the interests of Compartamos’ clients. In our view, this question is more troubling than most of the others associated with the company’s development between commercialization in 2000 and the IPO in 2007.

Although the Compartamos IPO may stimulate investors’ interest in other MFIs, it may also have less fortunate results for some other MFIs in Latin America and elsewhere. A number of countries are seeing a strong backlash against high microcredit rates from populist politicians, media, and social activists. This populist critique usually ignores the fact that microcredit rates have to be higher—sometimes much higher—than normal bank rates even when MFIs are efficient and profits are modest. But

²¹ Some have suggested that the increase in Compartamos’ average outstanding loan size as it commercialized—from \$127 in 1999 to \$440 in 2006—reflects an abandonment of poorer borrowers. Loan sizes are sometimes driven by MFI policy rather than client poverty. A few years ago, Compartamos decided that its limit on initial loan size was a lot lower than it needed to be from a risk-management perspective. When it started to offer a range of initial loan sizes, almost all its customers immediately

the public example of Compartamos, where the interest rates and profits that fed into the IPO look surprisingly high even to a fair-minded observer, could add fuel to the flames. In the present environment, MFIs are going to have to pay more attention to the political consequences of their interest rates.

C. Will growing competition restrain

Compartamos' interest rates and profits?

Fortunately (from the clients' perspective, at least) there are signs that competition is finally setting in.

Conventional competition theory posits a "take-off" stage when additional providers have entered a rapidly growing market, following the lead of initial pioneers, but the market is still a long way from being saturated. During this phase, firms are expected to compete more on product design or service quality than on price. Full price competition comes later, as the market gets closer to saturation and growth slows.²²

Compartamos has always faced some degree of competition, because its clients have, and use, other borrowing options, including informal sources, vendor credit, and sometimes credit cards or consumer loans. These services have characteristics that are quite different from Compartamos loans, so the competition has been indirect. But this indirect competition is heating up, as Mexican banks and other firms move down-market toward retail services because the market for corporate banking has become so competitive.

In addition, well-financed for-profit competitors are offering services that compete more directly with Compartamos, namely working capital loans to

opted for the highest option, making it obvious that the earlier loan sizes were not an indication of their borrowing needs and desires. This factor—Compartamos gaining more confidence in its ability to give clients the bigger loans they wanted—has no doubt driven a substantial part of the loan size increase. On the other hand, Compartamos certainly understands that, at a given interest rate, big loans are more profitable than small ones. But even if it is aggressively cultivating borrowers who want larger loans, that does not necessarily mean that those who want to borrow lesser amounts are being squeezed out. It is becoming clear that branch location is one of the strongest determinants of client poverty, so we would hesitate to conclude that there was substantial "mission drift" at Compartamos unless we saw evidence that the distribution of its branches had moved in the direction of more affluent neighborhoods. Discussions about mission drift in an MFI are usually frustrating, because the question can almost never be answered from publicly available data.

²² See Porteus (2006).

unpaid microentrepreneurs. Pronegocio is a subsidiary of Banorte, a large Mexican bank, that has about 67,000 clients and is growing fast. Compartamos' most serious present competitor is Finsol, owned by a group of ex-bankers from Banorte. With 175,000 clients, Finsol is operating in the same rural environments where most of Compartamos' customers are, uses a similar village banking methodology, plans to compete with Compartamos for deposits, and is aggressively poaching customers and staff from Compartamos branches. Like Compartamos, Finsol in 2006 had a high interest yield (81%) and was very profitable (ROAE = 44%).

The Mexican microcredit market is still far from saturated, so it may be a while before Compartamos is forced to lower its prices to levels that produce a normal profit margin on its loans. But we still expect that each succeeding year will reduce Compartamos' freedom in pricing its products, put tighter limits on its profitability, and force it to seek greater efficiencies.

2. Was the aid money granted to Compartamos in its early years used inappropriately to enrich private investors?

As noted earlier, the IPO produced huge profits for private investors. In this section, we analyze the relatively narrow issue of whether donor grants and other soft funding made their way into private pockets (Table 6).

Virtually all of the grants supporting Compartamos operations went to not-for-profit NGOs and stayed there, without leaking into private pockets. No grants were made to the finance company. ACCION lent \$1 million of its 2000 USAID grant to the finance company, which has already repaid the loan. ACCION and the Compartamos NGO used grant money to buy equity shares in the finance company, but of course retained those shares and rights to all profits accruing from them.²³ The huge capital gains that were realized on the sale of those shares in the IPO go back to the NGOs and are used to fund their public-purpose work.

The Compartamos NGO received over \$100 million from the IPO, which will be used to expand its

²³ ACCION's share purchase in the finance company was funded, not by the \$2 million USAID Compartamos grant shown in Table 1, but by earlier USAID and CGAP grants to ACCION's Gateway investment fund.

Table 6. Grants and Soft Loans for Compartamos Operations

Year	Source	Amount (\$000)
1990	USAID	50
1993	IDB grant	150
1993	IDB loan (near-grant terms)	500
1995	Alfredo Harp & family	1,300
1995–98	Other private Mexicans	300
1996	CGAP	2,000
2000	USAID (to ACCION)	2,000
	Total	6,300

Note: This table does not include the ACCION Gateway Fund's 1998 share purchase of \$1 million. Gateway assets at the time came largely from earlier USAID and CGAP grants that were intended for investment in unspecified MFIs and, thus, did not target Compartamos.

work focused mainly on health and nutrition for poor Mexicans. ACCION sold off a larger percentage of its shares and cleared about \$135 million, which it will be using to further its work supporting MFIs around the world. When IFC's \$40 million is included, about five-eighths of the sale proceeds have gone back into organizations whose assets are used for development purposes and are not distributed to private owners.

Private individuals captured over \$150 million from the sale. It is legitimate to question whether profits this large are appropriate for a company that has always presented itself as wanting to balance commercial and social objectives, as discussed in the previous section. But these private individuals' shares in the company were not financed with public-source money.

It is true that the donor grants funded operations at an earlier, and therefore riskier, stage of operations. In recognition of this, the Compartamos NGO received a premium over and above the face value of the loan portfolio that it transferred to the finance company. One can always argue about whether the premium was a fair one, but that question had to be answered in 1998, without the benefit of hindsight. We are inclined to think that the finance company was still a high-risk proposition for private investors in 1998. Many, if not most, of the

private investors in the finance company were motivated by social as much as by financial objectives at that time.²⁴

In addition to \$6.3 million in grants to the Compartamos and ACCION NGOs, there has been over \$45 million in loans from development agencies and social investors to the for-profit finance company and bank. Some of these loans have had a degree of a concessional element—for instance having longer terms or lower collateral requirements than a commercial lender might have offered, or the protection from domestic political risk that comes from having public international investors. These modest concessional dimensions no doubt benefited the company, including its minority of private investors. The same thing happens in most of the operations of such development-oriented lenders, so there was nothing unusual in this regard about their Compartamos investments. The main point is that the interest rates Compartamos pays for these loans have generally been at commercial levels or even above.

On balance, our view is that the public aid money given to Compartamos has not been inappropriately diverted to private pockets. Indeed, we think the grant money has been deployed quite successfully from a development perspective. By the end of 2006, before the IPO, the \$6.3 million in grants had catalyzed over \$130 million in private purely commercial resources. Compartamos will now start using its banking license to mobilize deposits. If one assumes enough deposits over the next four years to leverage its equity capital to the same degree as a typical Mexican bank, then by 2010 the bank will have captured over \$1.2 billion in purely commercial funding, equivalent to 80 percent of its total assets.²⁵ Another optic is to compare the donors' original grant investment with the number of borrowers

²⁴ It is worth noting that a quarter of the donations to the Compartamos NGO came from private Mexican sources, mainly the Harp family, which later also paid for a 10 percent share of the finance company.

²⁵ These figures include money raised from outside sources only; they do not include the company's retained earnings. The projection assumes that Compartamos' non-deposit liabilities stay the same and that profits drop to a 20 percent return on equity, which is still above the Mexican bank average of 15 percent. If 50 percent profits are assumed, purely commercial funding would account for about 75 percent of the bank's assets by 2010.

reached: as of the end of 2006, grant input amounted to about \$10 per current active borrower, a figure that will continue to shrink as Compartamos' outreach grows.

3. Does the IPO change the governance of Compartamos in ways that will make it harder to balance social and commercial objectives, especially when there are choices to be made about whether money goes into shareholders' pockets or clients' pockets?

The more of Compartamos' shares are in the hands of private commercial investors, the harder it will be to make decisions that do not maximize investor profits. After the IPO, the not-for-profit institutional shareholders are now a minority by a tiny margin, although they still have enough shares to retain effective control on issues where they vote together.

The high IPO purchase price paid by the new shareholders sets in place high expectations about profitability. The price on the initial sale of the shares was 27.1 times the company's 2006 earnings. The bid-up of Compartamos shares in subsequent trading raised the price-to-earnings ratio (P/E) substantially higher. By way of comparison, the average 12-month P/E for the middle-sized companies in the S&P Mid-Cap 400 Index was 19.9 as of March 31, 2007, and the comparable figure for the Mexican stock exchange as of January 31, 2007, was 19.3. The practical implication is that the new purchasers cannot realize a respectable return on their investment unless future profitability is considerably higher than it already was in 2006. Some additional profitability can be expected as Compartamos starts using relatively low-cost deposits to expand its loan portfolio. But in light of what the new investors have paid for their shares, they will certainly have little sympathy for interest rate policies that do not stretch profits to the maximum.

At the same time, it is important to recognize that the tension between social and commercial objectives did not begin with the IPO. It began with commercialization in 2000. Here again, the IPO is not the most basic issue. It simply brought into stark relief an issue that was created when the finance company took in private for-profit investors.

For us, the Compartamos commercialization and IPO reinforce a message that others in the industry have been emphasizing for some time now: *those of us who are involved in MFI transformations may need to be clearer and more realistic in dealing with the inevitable governance consequences of those transformations.*

If the focus belongs, as we think it should, on dealing with the future more than on judging the past, then this is probably the most important lesson revealed by the Compartamos experience. When microfinance operations move from a nonprofit entity to a for-profit one, complex issues of governance, incentives, and ethics are created. We wish we were in a position right now to make more practical observations about how to resolve these issues, if only to avoid the anomaly of this most important point in the paper getting such brief treatment. But developing a consensus around sound practice in these circumstances will take more thinking and discussion with our colleagues inside and outside the microfinance community.

We at CGAP ask ourselves whether we bear any responsibility for this situation. Our 1996 grant of \$2 million to the Compartamos NGO included no covenants about future interest rates or profit levels. Such covenants would probably have been inappropriate or impractical for several reasons, but in truth, we never gave much consideration to the possibility that Compartamos would be charging such interest rates, and generating such profits, 10 years later, after private investors had been brought into the picture. We thought the motivations of the early leaders, or at least eventual competition, would keep things in reasonable bounds. We still hope—indeed expect—that competition will reduce rates and profits in the sector, but it is taking a long time.

More generally, since our founding in 1995, CGAP has been vocal about the need for interest rates that are high enough to cover costs, but we have been less emphatic about the loss to clients when interest rates are driven by inefficiency or exorbitant profits. We never made concrete predictions about how quickly competition would fix these problems, but we were probably too optimistic on this score. The Compartamos IPO gives all of us an opportunity to take another look at these questions.



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CGAP
1818 H Street, NW
MSN P3 - 300
Washington, DC 20433 USA

Tel: 202-473-9594
Fax: 202-522-3744

Email:
cgap@worldbank.org