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Growing a Middle East- Middle Class: Where Small Investment Goes a Long Way

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Summary

Political instability across the Middle East region has continued to keep investors away. But the unprecedented political and social transformation of the Arab Spring taking place offers tremendous opportunities to address the economic disparity and lack of opportunity faced by a rising middle class as well as poorer citizens who make up the majority of the population today.

In the midst of this chaos, there is a huge and catalytic role that small amounts of investment can play in supporting entrepreneurship and the growth of micro and small businesses in the Middle East, where more equitable economic growth and job creation is becoming imperative to survival. This article describes the role that these small amounts of investment can play and examines some of the models that have been used effectively to leverage private investment for the benefit of low and medium incomes families. It highlights the case of CHF International and its experience in bringing private capital to underserved markets in four countries in the Middle East.

Financial Inclusion in MENA

According to a 2009 study by the Milken Institute, in developed countries, small and medium enterprises (SMEs) contribute to over half of gross domestic product and 57 percent of total employment; compared to 16 percent and 18 percent in the developing world. With this in mind, one can argue that supporting entrepreneurship and the growth of small businesses will accelerate more equitable economic growth and job creation.

The MENA region lags far behind other regions in outreach to both microenterprises and SMEs, and in developing policies aimed to address financial inclusion. As a result, there remains a vast untapped market in microfinance, and a still grossly underserved SME sector starved for capital to meet investment and expansion plans.

For example, according to the Consultative Group to Assist the Poorest (CGAP), the current penetration rate of microcredit services in MENA is at only 10 percent, with just over 2 million active borrowers out of an estimated potential of 20 million. Regulatory restrictions allow for credit only services (as a opposed to savings, insurance transfers), thus there is an even greater untapped market for savings (market of 200 million clients, 50% untapped), insurance (240 million clients, 99% untapped).

The 2011 Regional Snapshot for MENA Microfinance reports that microfinance providers in MENA made up just over $1 billion portfolio, with average loan size of $610. The Arab region has the lowest outreach compared to peer regions, and has also among the lowest per capital loan balance at 16% GNI per capital, following South and East Asia. This suggests that the low outreach is also targeting the poorer customers, which is in line with its NGO provider profile – NGOs make up 70% of the MENA industry. This also suggests that the slightly larger micro and small business customers, those arguably with more potential for investment, growth and job creation, remain left out. In fact, corporate and SME clients in MENA make up just 5% of the total portfolio, compared to 38% in Europe, 18% in Latin America, and 13% in Africa. On a positive note, MENA has the lowest medium Portfolio at Risk and therefore the highest portfolio quality. It receives the lowest cross border funds and relies primarily on donations, receiving just 6% of global commitments of funding.

In terms of SME outreach, according to a recent IFC / McKinsey study, there are between 1.9 and 2.3 million formal SMEs in the MENA region, and the SME financing gap is estimated to be in the range of $110 billion to $140 billion. SME lending as a percentage of total lending (SME lending ratio) for banks in MENA averages eight percent -- far below OECD countries where SME lending averages 27 percent of total lending. This is despite the fact that most major banks in the region hold abundant loan capital and are generally underleveraged. Although more than half of the formal SMEs in MENA maintain bank accounts, most do not have access to credit.

The table[1] below illustrates that Egyptian banks would need to increase the SME portion of their total lending by $14 billion in order to reach an SME lending ratio on par with OECD countries. Egypt noticeably lags the other MENA countries in terms of SME lending as a percentage of total outstanding loans. Egypt's SME loan balance represents less than seven percent of total loans.

[1] Rocha, R., Farazi, S., Khouri, R. & Pearce, D. (2011, January) The Status of Bank Lending to SMEs In The Middle east and North Africa Region: *The Results of a Joint Survey of the Union of Arab Banks and the World Bank*

Table 1: Bank SME Lending Ratios by Country					
Country	Total Banks	Total Loan Balance (US$ billions)	SME Loan Balance (US$ billions)	Potential SME Loan Balance (US$ billions)*	Increase in SME Loan Balance to Reach OECD Levels (US$ billions)
Egypt	40	69.6	4.6	18.7	14.1
Tunisia	24	24.7	3.8	6.6	2.8
Jordan	23	18.8	2.0	5.0	3.0
Morocco	33	69.9	16.6	18.7	2.1
Lebanon	68	59.3	9.6	15.9	6.3

*If SME lending increases to OECD level of 26.8 percent of total 2009 loans

Sources: Research compiled by Arun Hsu, Senior Technical Specialist, CHF International. Central Bank of Egypt, Central Bank of Tunisia, Central Bank of Jordan, Central Bank of Morocco, Central Bank of Lebanon, International Monetary Fund (IMF), The Union of Arab Banks and The World Bank

Models that Work

Microfinance – Microfinance has become a well known industry in its own right, albeit not without recent controversies around overindebtedness and real or perceived impact on the poor. Many of the criticisms are valid and are a welcome wake up call to investors to see through the hype of promised easy returns with little risk and doing good all the while. However, the mainstay institutions that have earned a reputation for the industry cannot be overlooked or their impact slighted. Since the 1970's sustainable microfinance practices have been replicated in nearly every country around the world, with impressive growth and outreach to previously unbanked populations. Some of the top tier microfinance banks boast outreach of more than 300,000 customers and sustain positive returns above 10%, adopting technology and sound management approaches that rival or exceed the best commercial banks. Scale and efficiency has largely come through transformations from an NGO-led industry to a business-oriented sector that can attract social capital, incorporate good governance practices, and manage investor stakeholder expectations. One can easily point to top tier microfinance banks in Bolivia, Peru, Colombia as well as institutions in Eastern Europe and Central Asia. The MIX Global 100 ranks MFIs every year according to criteria based on outreach, transparency and efficiency among others.

Where there are targeted interventions to micro enterprises, even if on average only employ a few people – they do create job opportunities where very few exist. The still limited outreach in MENA is partly due to a lack of foreign investment partly as a result of poor incentives to invest, in light of a largely public sector or donor-driven mindset. It is also due to lack of favorable regulations that promote competition, ease of entry and doing business.

SME finance – Small and Medium Enterprises (SMEs) are crucial drivers to economic growth, creating jobs and providing income to people who own and work in them. The small end of SMEs (the S of SME) are often the entrepreneurial engines of growth, particularly among young people ages 25 to 30. It is difficult to sustainably finance this segment due to the lack of clear financial statements, and knowledge gap that exists for the financier to comfortably take a risk. Several organizations have developed methodologies in underwriting these small businesses and some microfinance institutions are beginning to "reach up" to also serve the "missing middle" small business client segment, particularly as microenterprises grow with them as clients over time. The ANDE Network has developed a membership of organizations working to address the small and growing business sector, among which are Small Enterprise Assistance Fund, Growfin, Grassroots Business Fund, and CHF International, to name a few. Aside from specialized SME providers, there is a long history of guaranty schemes over the last decade or so to motivate banks to serve the SME market. Many of these schemes have shown mixed success: The culture shift needed for banks to profitably serve this sector is hard to put in place, and in many cases the guarantee must stay in place for banks to continue to serve this sector, defeating the purpose of the incentive to prove SME lending can be a profitable market. However, in the long run, banks should be serving this market segment, as they have most capacity to "fully bank" the small business owner and provide the range of services needed (lines of credit, insurance, transfer services, business checking etc.).

Specialized Investment Vehicles -- Over the last 5 to 10 years, there has been an explosion of specialized funds established to target the microfinance – and increasingly the broader space of social enterprise or socially responsible investing. Specialized Microfinance Investment Vehicles (MIVs), including Fund of Funds vehicles, multilateral development agencies such as Overseas Private Investment Corporation (OPIC), International Finance Corporation (IFC), and many European banks (EBRD, KfW, etc.) have all targeted support in both technical assistance grants as well as debt and equity investments in funds or directly in an individual institution in the microfinance and SME sectors. In its annual survey The State of Microfinance Investment 2011, MicroRate estimated that the total assets of MIVs as of December 31, 2010, was $6.4 billion, represented by 80 participating MIVs. Since 2005, when MicroRate first collected data on MIVs, MIV assets have grown steadily, albeit at a slower pace in recent years, from $1.2 billion to a record $6.4 billion in 2010.

The entrance of private capital has been welcome in the industry as donor funds have dried up. It has also raised the bar on the quality of governance in local institutions, though more is still needed. CGAP's recent report on good governance reveals that active board seats by qualified members of the investor community, making an equity investment in institutions, can go far to raise standards, and professionalize systems, particularly with regards to risk management. While the bulk of funding is still in the form of debt financing, equity investments have steadily increased and made up 18% of the total.

All these models demonstrate the power of leveraging small amounts of private capital to get big results.

The Case of CHF International

CHF International is the largest international network of microfinance lending in the Middle East, with nearly 80 percent of its $132 million outstanding portfolio worldwide concentrated in four countries: Jordan, Lebanon, West Bank & Gaza, and Iraq. In the MENA region alone, CHF has over 68,000 active borrowers and 700 employed staff - all of whom are of Arab origin. CHF serves a broad spectrum from micro to small and medium businesses, what it considers to be the "missing middle" enterprises that are too large to be served by traditional microfinance institutions, but too small for commercial banks. In addition to its microfinance activities, CHF also manages large loan guaranty facilities that use private risk capital to create incentives for commercial banks to expand lending to small and growing businesses.

CHF's customer base of microenterprises typically employs one to five people and loans range from US $500 to US $10,000, averaging US $2000. Part of CHF's success in the region lies in the fact that the people and families it serves are the low and median income, working class: they have no other choice but to stay in the country, they are committed to making things work, and they pay back. They cannot flee their country even in the event of an emergency – they have to invest in it and in their future to build a better country for themselves and their families. This level of commitment is seen in CHF's repayment rates: in MENA they are its highest, above 98 percent. In Iraq, CHF pioneered Islamic compatible lending models during its early years of operation in Iraq. This paved the way for a community-driven, demand-led model of financial services for microentrepreneurs that today is the largest in the country. In Iraq alone, CHF serves over 22,000 borrowers with a portfolio outstanding of more than $48 million. It disburses approximately $6-7 million every month in $3800 average transaction size, and with a portfolio at risk over 30 days of less than a quarter percent (0.18%). Currently, the challenge for CHF in Iraq, and other countries in MENA, is accessing capital to keep up with that demand. For this reason, CHF has pursued a local company license in each country to serve as a vehicle that opens the doors for both debt and equity investments that can fund growth, as traditional donor funds dry up. Thus far, CHF has obtained the first ever financial company license from the Central Bank in

Lebanon, and is in the process of company registration in Jordan, West Bank and eventually, Iraq.

CHF's MENA Loan Guarantee Facility. CHF has hit on some key criteria that have made a new and improved model of loan guaranty facilities pay off. It is simple: Think like a bank. Show that there is profit to be made; the rewards are greater than the risks. Take away enough risk to be palatable to the credit team. Build the back office to handle small loans and the front line staff with profiles that suit the SME client. This is not done overnight, but there is a slow culture shift among champions in the banks that see how to profitably serve this sector, largely driven by the shadow relationship of CHF staff that intermediate between the bank and the guaranty. Loan officers get immediate feedback on their underwriting of a small business, and loan rejection rates in CHF's experience come down from 60 percent to under 20 percent within the first year. This hands-on approach is expensive, and requires an appropriate subsidy from a development bank or donor. In Jordan, with US $9 million grant, and US $250 million in guarantees, the program can leverage US $800 million in capital over the next 10 years to support SMEs.

Of CHF's global portfolio of active loans, worth US$ 132 million, 39 percent is sourced from private capital. Considering the original amount of seed capital was $53 million, sourced initially from a small donor grant by USAID or other donor, $26 million has been built up in retained earnings over time, the CHF network remains significantly underleveraged at 0.63x and leaves substantial room for future debt financing to support future growth.

Major Sources of Investment

Commercial banks - CHF was one of the first organizations to pursue a bank partnership model with local, private commercial banks. Since the 1990s, the exchange in knowledge transfer has been tremendous. It has more than 15 commercial bank partners across the Middle East, many of which are relationships established now for more than 10 years. These relationships range from brokerage of services to reach the low-income customer segment, credit life insurance and cross selling of other products, credit line facilities and term loans, joint credit committees, technical assistance and advisory work, and managed guarantees.

For example, Vitas Lebanon was founded in May 2003 as Ameen S.A. L. service company, with the object of continuing the USAID funded microfinance program started by CHF International, in October 1998. It later received the first financial company license in Lebanon and today operates as a subsidiary company under CHF's holding company Vitas Group (see below). The model was initially based on a partnership with commercial banks, wherein the banks extend microfinance loans to clients and manage clients' accounts, with Vitas Lebanon "servicing" these loans (promotion, loan origination, maintaining regular contact with existing clients, and loan follow up in cases of default).

Initially, banks assumed a small percentage (25 percent) of risk and capital share on every individual microfinance loan, with Vitas assuming the remaining 75 percent. Over time, with a proven track record, the risk and capital share have shifted to a majority (75-100 percent) of bank capital and a more even risk share (with Vitas assuming <50 percent, or 10 percent on first loss up to a cap depending on the bank.)

As a result of this model, with just US $2.5 million in initial seed money, Vitas has been able to leverage around $150M in private capital loans to microentrepreneurs across a branch network of 73 among four private bank partners

Multilaterals - CHF and the Overseas Private Investment Corporation (OPIC) have a long-standing and unique history of collaboration. In 2002, OPIC established its first debt facility with CHF to provide loan capital for on-lending to CHF microfinance subsidiaries in Mexico and Romania. Since then, the OPIC-CHF partnership has grown to support a range of CHF initiatives. These include direct loans to CHF subsidiaries, loans to CHF for on-lending to microfinance programs, establishment of special purpose vehicles (SPVs)/companies that provide loans to middle market businesses, guarantee facilities managed by CHF in partnership with local commercial banks, and mortgage facilities managed by CHF or a CHF subsidiary, in partnership with banks. These programs all share the common goal of revitalizing economies torn apart by conflict, and where the banking sector has been reluctant to enter the market. With OPIC financing, CHF has been able to expand its role as a direct implementer and actor in the markets to stimulate private sector growth and strengthen local bank capacity to ultimately serve this market. Because OPIC is able to provide much longer term funding than most lenders, it has allowed CHF to focus on developing a business model that can target the full spectrum of financial needs for micro, small and growing businesses -- the "missing middle" -- in countries where ordinary lenders will not go.

Today CHF is OPIC's largest non-profit customer. A current list of transactions includes direct loans for onlending to microfinance institutions, loan guaranty facilities in partnership with commercial banks, mortgage facilities in partnership with government and bank partners. All told, the OPIC –CHF partnership has resulted in over $850 million committed funds to date.

A New Model for Equity Investment - The Vitas Group, a holding company majority-owned by CHF, was established to own and manage CHF's commercially-oriented microfinance subsidiaries. The new company will consolidate the rich experience of its subsidiaries under one shared vision, of "financing a better world," and position the company to grow CHF's global microfinance network in a consistent, socially responsible manner.

In recognition of the increasing amount of capital required to achieve scale and greater social impact, last year CHF closed its first minority equity investment with Blue Orchard Private Equity Fund in a new vehicle set up to attract such investments. Blue Orchard's entry marks the first of several capital injections that CHF Development Finance International is planning to raise from private sector like-minded social investors, as the company further consolidates other CHF microfinance operations and expands into new countries.

Through innovative vehicles like Vitas, and the great strides that CHF and others in the development industry are making to create models that blend private, public and donor funds to maximize impact, there are ever increasing opportunities to attract more and varied sources of financing required to help meet the needs of the low income customers and small businesses around the world.