

# **Growth, Profitability, and Compensation - How Much is Too Much?**

**(This is most definitely the  
right question!)**

Chuck Waterfield  
SPTF Panel  
Jordan  
June 2012

# Expansion of my SPTF presentation

- We had a panel on : Growth, profit, and compensation levels
  - We were allowed 3 slides (one per topic) and 2 minutes per topic
- The topics are extremely important to me
  - I have been speaking on these topics for over four years
- I've chosen to elaborate on what I said at SPTF in Jordan
- I believe it is time for the industry must make some hard decisions which we have been avoiding

# Aggressive Business? or Responsible Business?

- Growth, profit, and compensation levels
  - All three are correlated by aggressive business practices that put the interests of the business owners/managers above those of the clients
  - If unchecked, all three have the danger of drawing microfinance into the realm of the 1000 years of moneylending that preceded us.
- And central to all three is the motive of personal wealth
  - Growth is often pursued primarily to generate more profit for investors
  - Profit leads to higher executive compensation, executives who often are also investors benefitting from the profit
- Responsible Practice? All this wealth comes directly from those living at the Bottom of the Pyramid

# Growth and Over-Indebtedness

# Growth and Over-Indebtedness

*“Compartamos’ greatest achievement was having inspired so much competition that the number of microfinance institutions (MFIs) in Mexico grew from 200 in 2006 to 2,000 today.”*

Alvaro Rodriguez, Board Chair, Compartamos

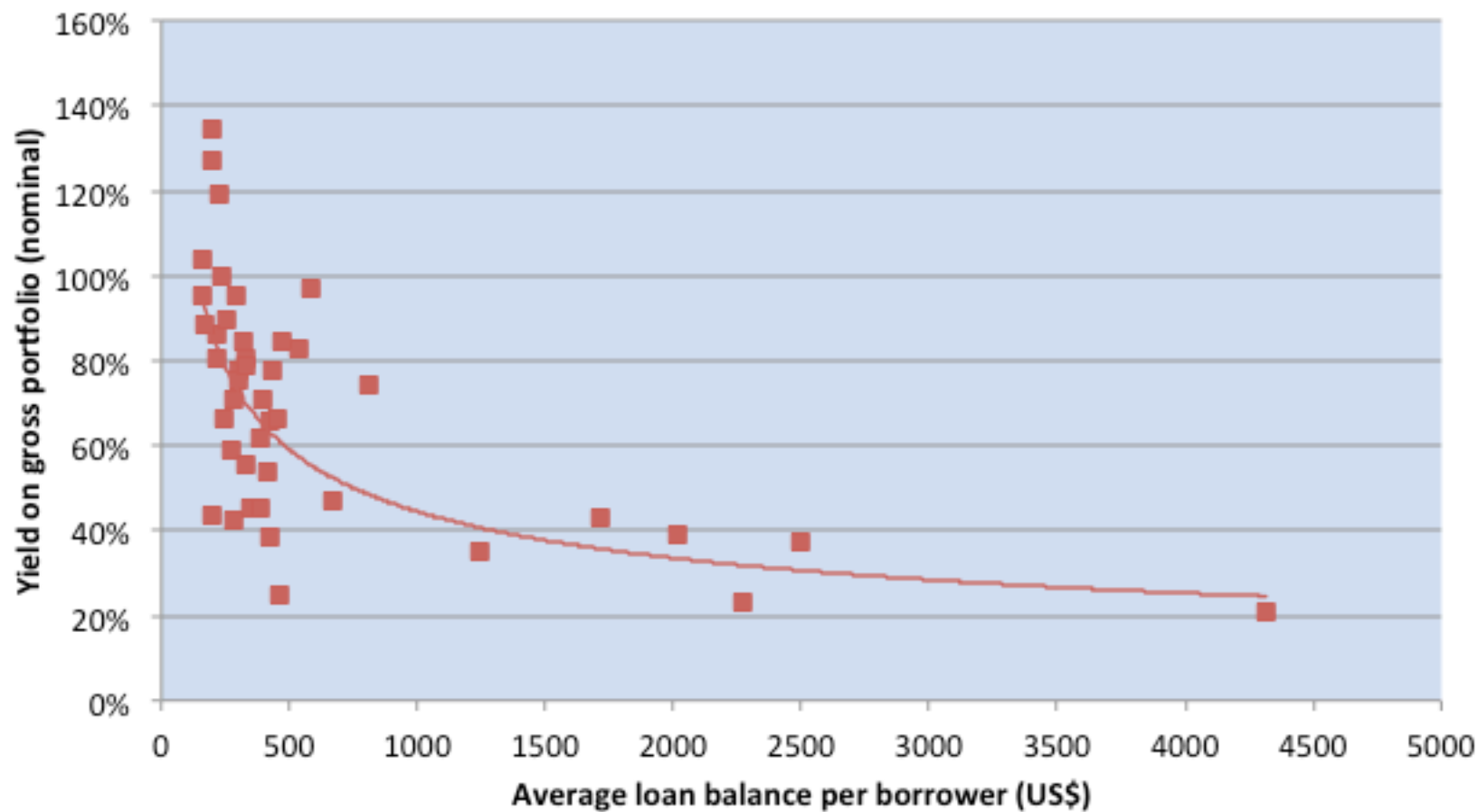
- Do the poor in Mexico need 2,000 sellers of credit?
- How many of those 2,000 are committed to responsible practice
- How many have been attracted by quick, high profits?
- Is this truly consistent with the original vision of microfinance?

# Mexico MFIs with > US\$1M in profit in 2010

Institution	Profit
CompartamosBanco	\$208M
Financiera Independencia	\$45M
CAME	\$6M
Apoyo Economico	\$6M
FINCA - MEX	\$6M
Invirtiendo	\$4M
Conserva	\$2M
Te Creemos	\$2M
Mas Kapital	\$2M
Solucion Asea	\$2M
FinComun	\$2M
SolFi	\$1M
Forjadores de Negocios	\$1M
<b>Total</b>	<b>\$287M</b>

## Yield on gross portfolio (nominal) vs Average loan balance per borrower (US\$)

Data for 51 MFIs in Mexico, 2010



# Growth and Over-Indebtedness

2010 MIX Data on 51 MFIs in Mexico:

- Portfolio Yields average over 80%
- Over US\$200 million in profit

Over-Indebtedness is rapidly escalating

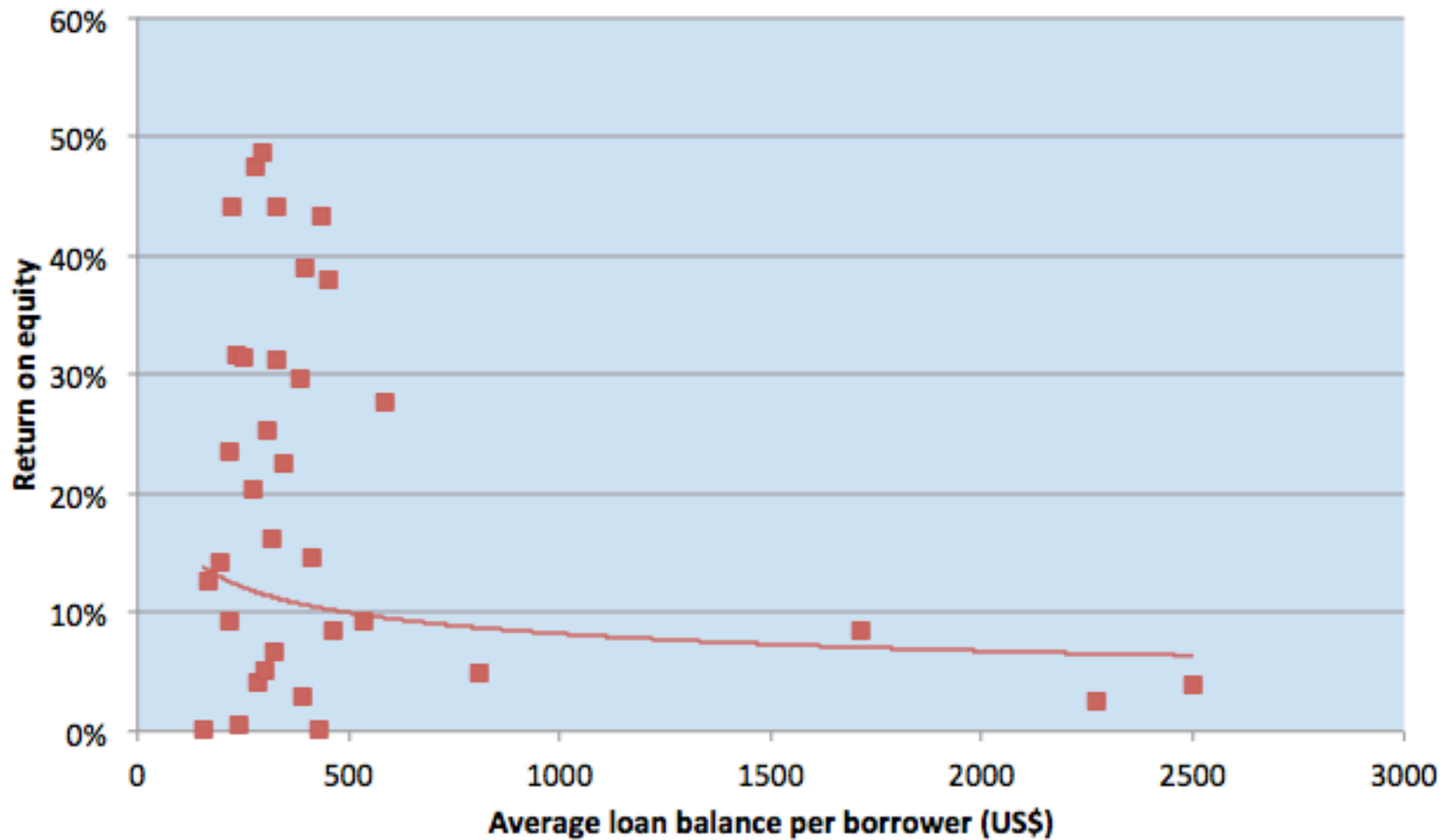
- How many loans at these prices can one woman borrower juggle before she goes bankrupt?



# Profitability: Understanding ROE

# Return on equity vs Average loan balance per borrower (US\$)

Data for 42 MFIs in Mexico, 2010

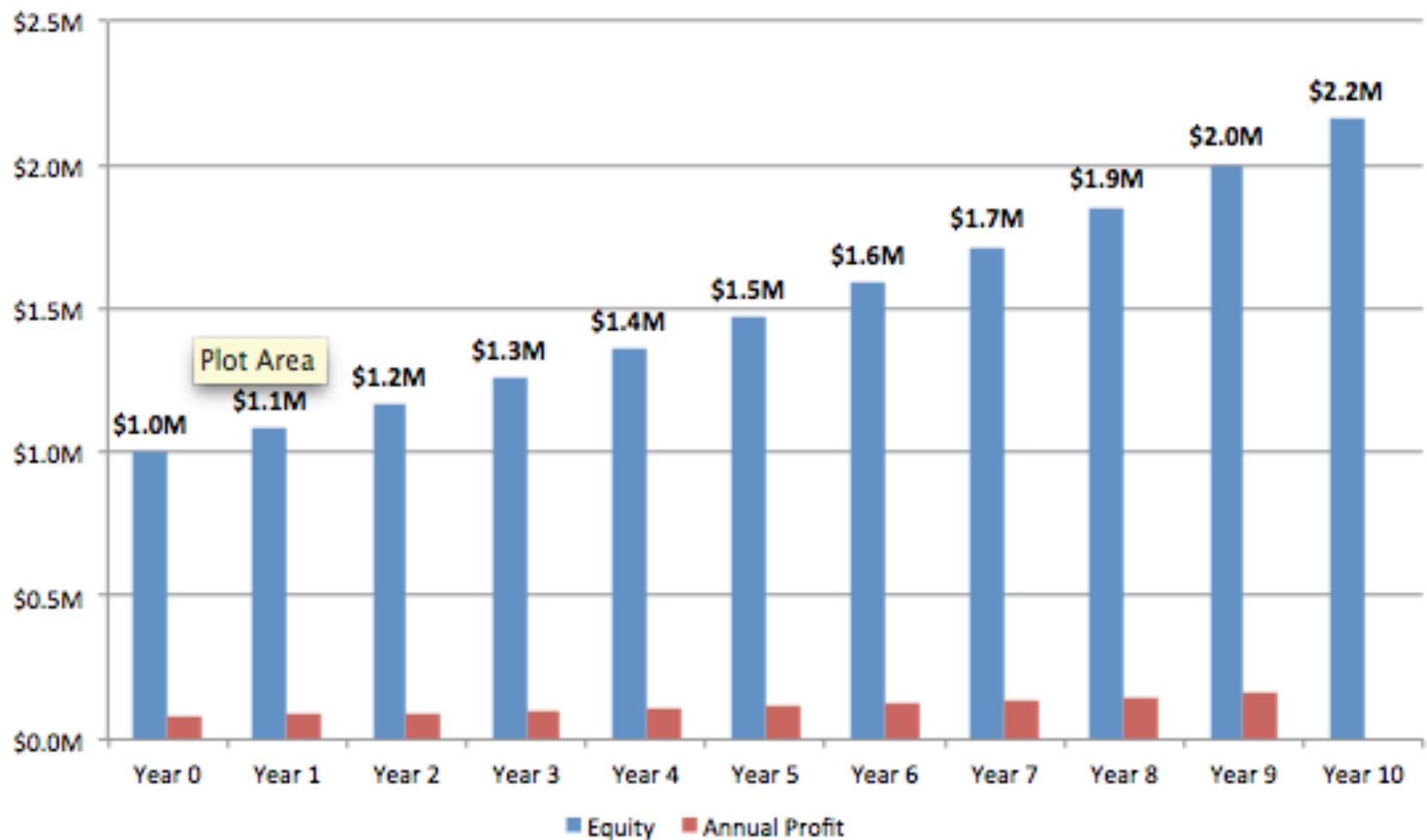


\* Negative ROEs filtered out to improve y-axis visibility

# Proposed Limits to Responsible Profit

Reference Point	
ROE of 8%	Typical market investment
Possible Benchmarks for ROE in microfinance	
<b>Less than 5%</b>	Red light – Insufficient for long term sustainability
<b>6% to 15%</b>	Green light – Healthy double bottom line institution
<b>16% to 25%</b>	Yellow light – The “grey area” in these benchmarks are colored “yellow” 😊
<b>Above 25%</b>	Red light – Excessive profits generated from the poor

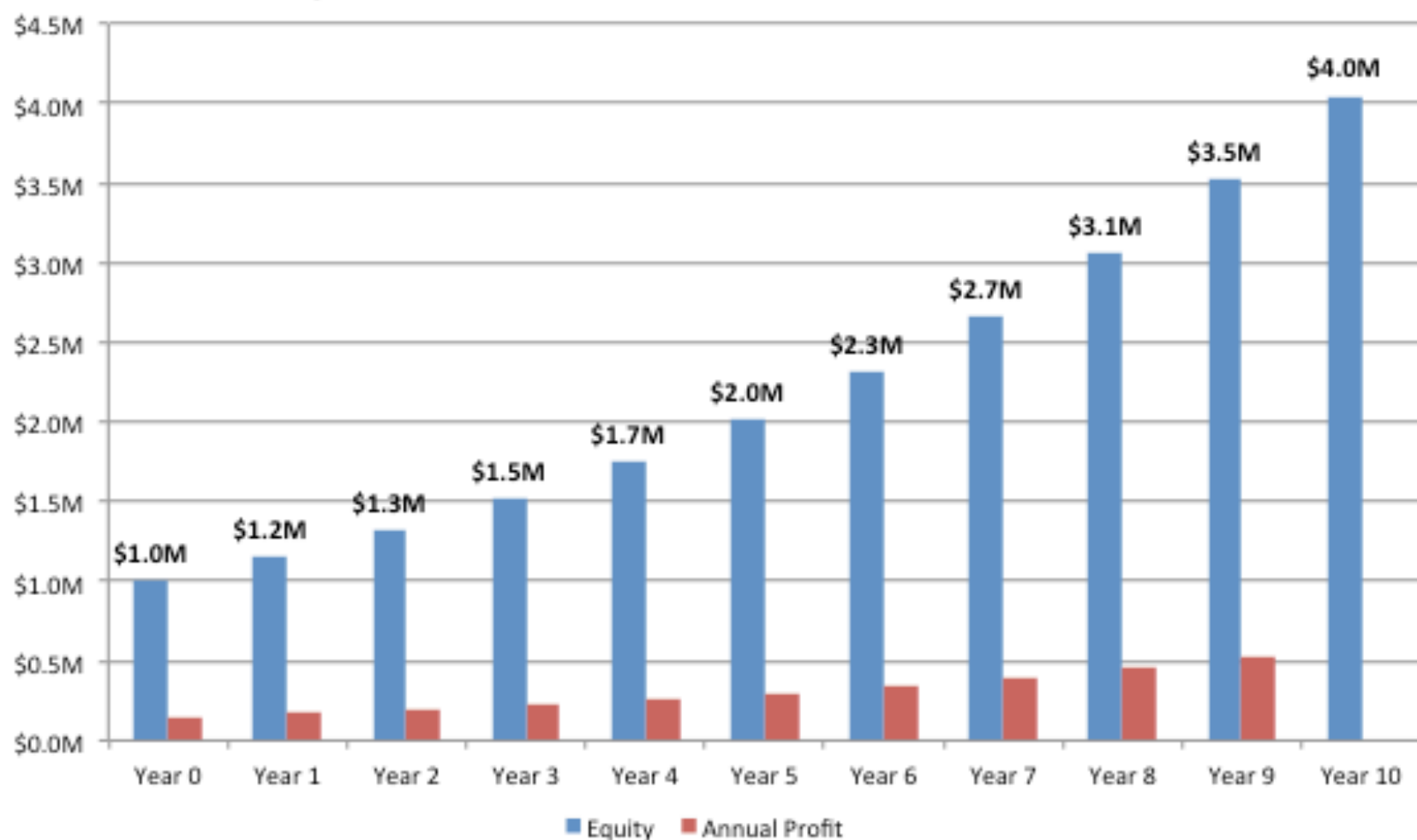
## Compound Growth over Ten Years at 8.0% ROE



In Ten years: **2.2** times initial investment

Amount that came from clients **\$1.2M**

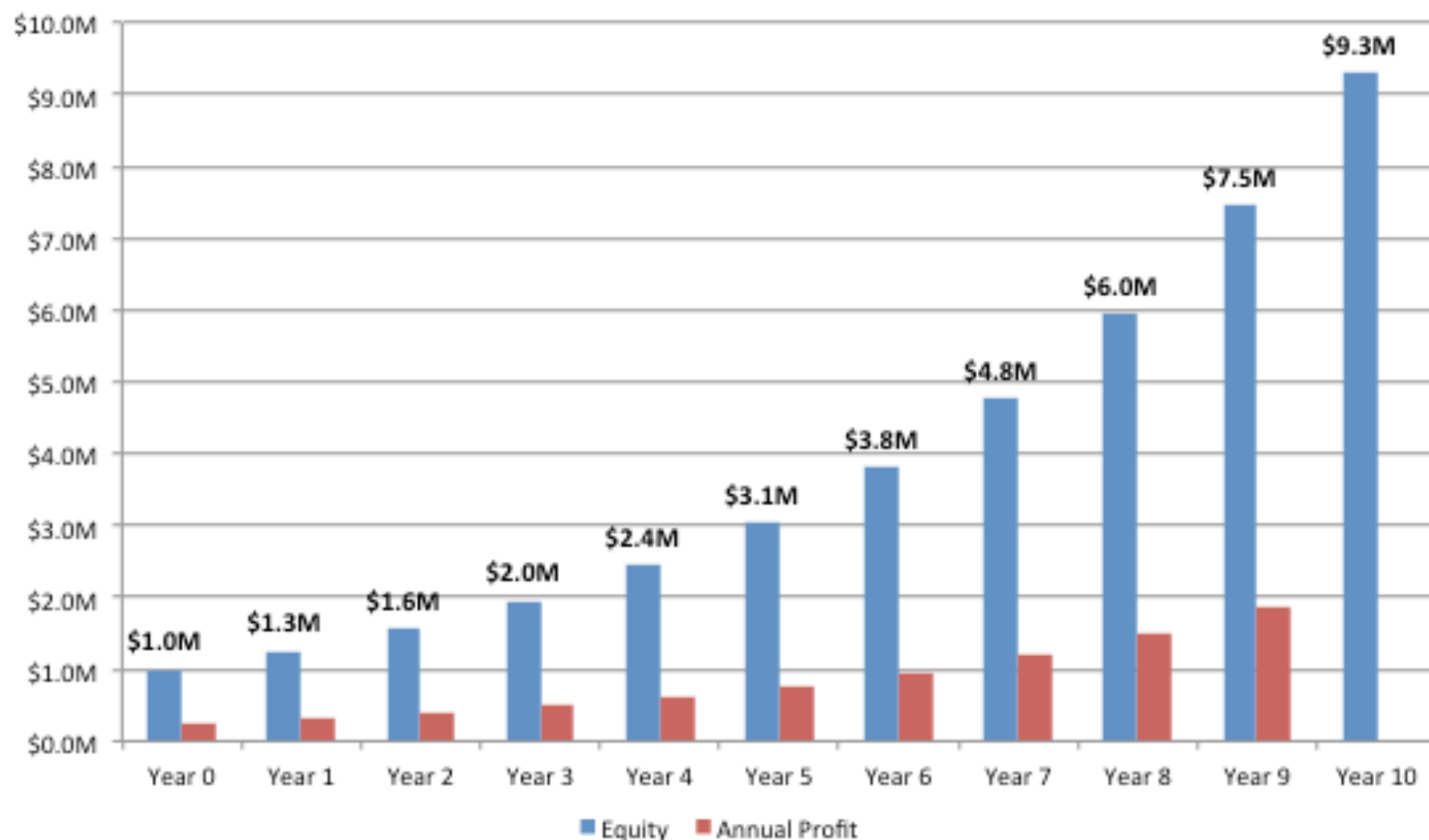
## Compound Growth over Ten Years at 15.0% ROE



In Ten years: **4.0** times initial investment

Amount that came from clients **\$3.0M**

## Compound Growth over Ten Years at 25.0% ROE



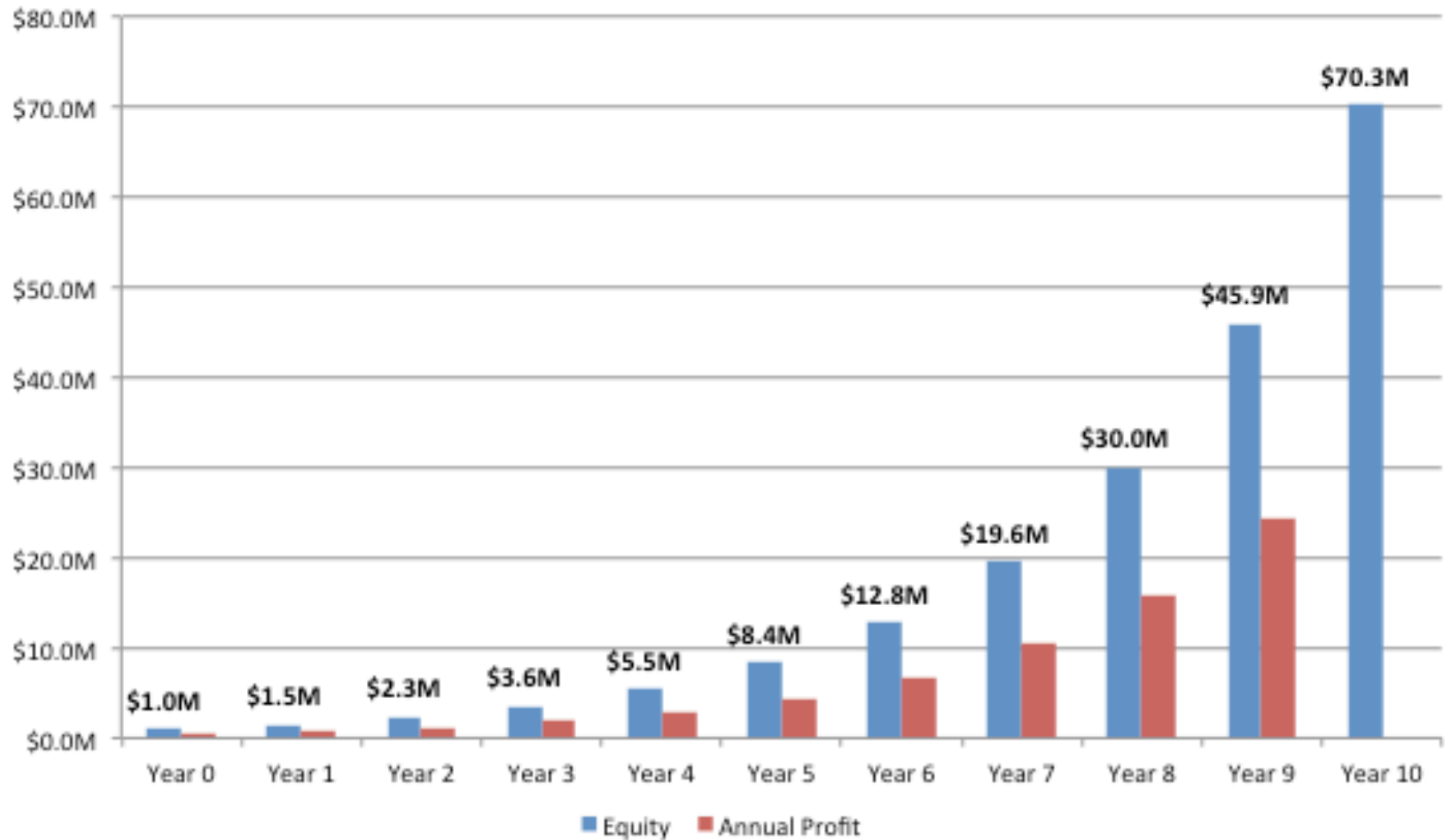
In Ten years: **9.3** times initial investment

Amount that came from clients **\$8.3M**

# Exceeding 25% ROE

- And what happens for “red light” growth, above 25%? How much profit really gets generated?
- Compartamos investors made a 300-to-1 return on their seven-year investment the day of the 2007 IPO. They maintain that a large part of this profit was made primarily off of investors, not clients
  - How much profit does Compartamos make directly from their clients rather than investors?
  - Compartamos, for the past ten years, has averaged 53% ROE

## Compound Growth over Ten Years at 53.0% ROE

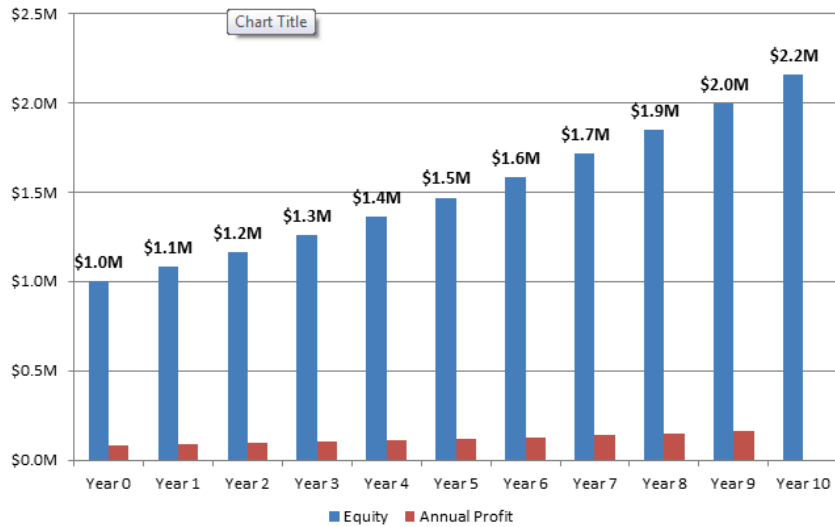


In Ten years: **70.3** times initial investment

Amount that came from clients **\$69.3M**

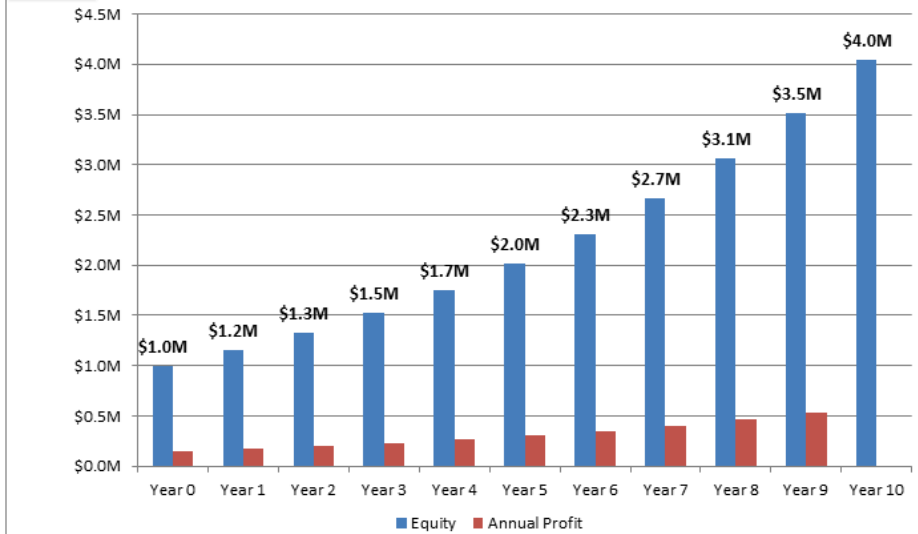


### Compound Growth over Ten Years at 8.0% ROE



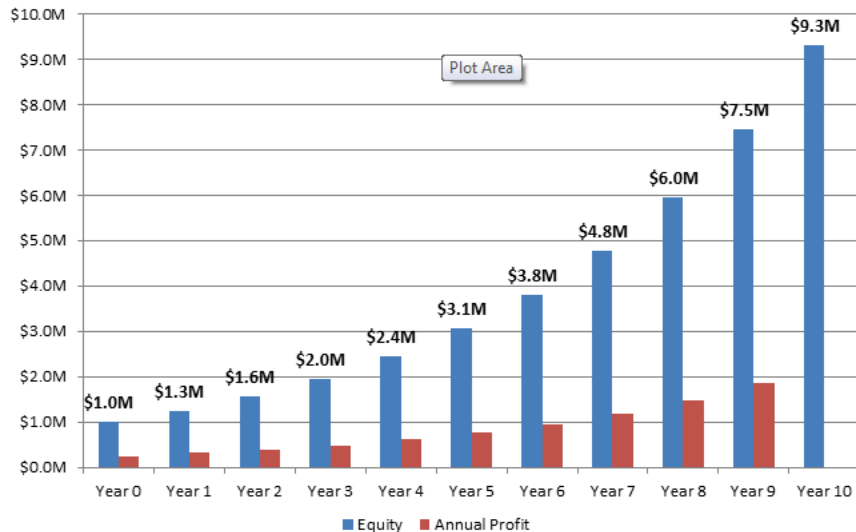
In Ten years: **2.2** times initial investment      Amount that came from clients **\$1.2M**

### Compound Growth over Ten Years at 15.0% ROE



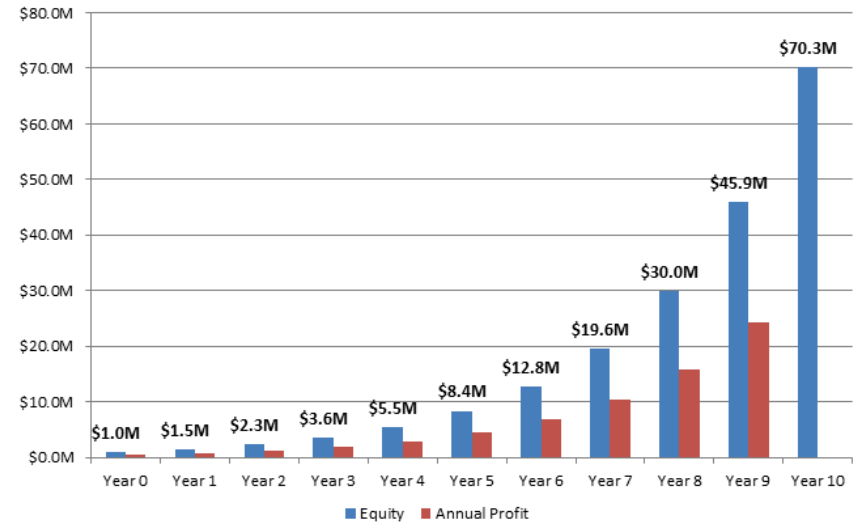
In Ten years: **4.0** times initial investment      Amount that came from clients **\$3.0M**

### Compound Growth over Ten Years at 25.0% ROE



In Ten years: **9.3** times initial investment      Amount that came from clients **\$8.3M**

### Compound Growth over Ten Years at 53.0% ROE



In Ten years: **70.3** times initial investment      Amount that came from clients **\$69.3M**

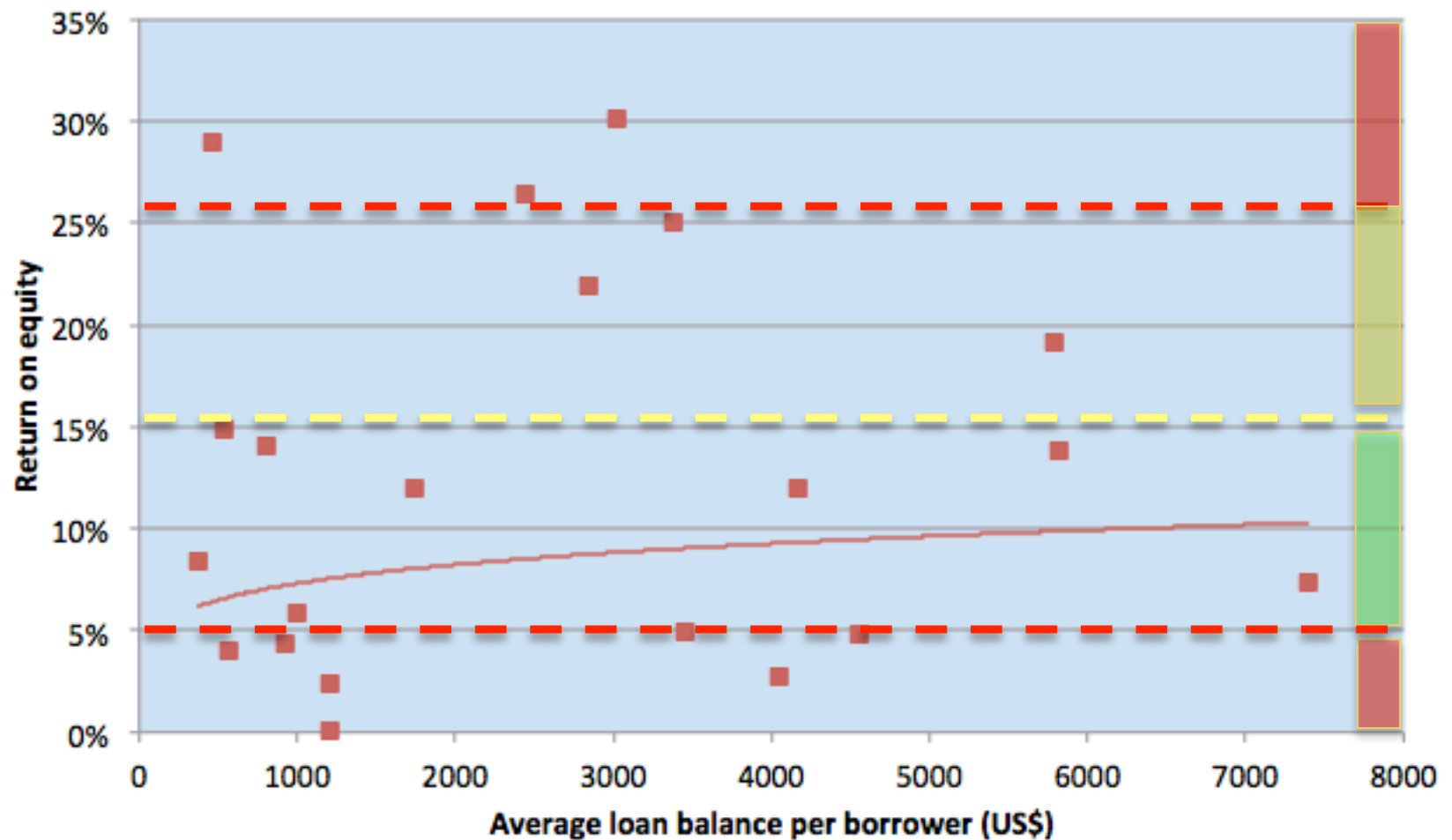
# Benchmark Comparison

Benchmark	In 10 years, \$1M becomes
8% - Typical market investment	\$2.2M
15% - Proposed limit for "green light"	\$4.0M
25% - Proposed limit for "yellow light"	\$9.3M
53% - Compartamos 10-yr Avg ROE	\$70.3M

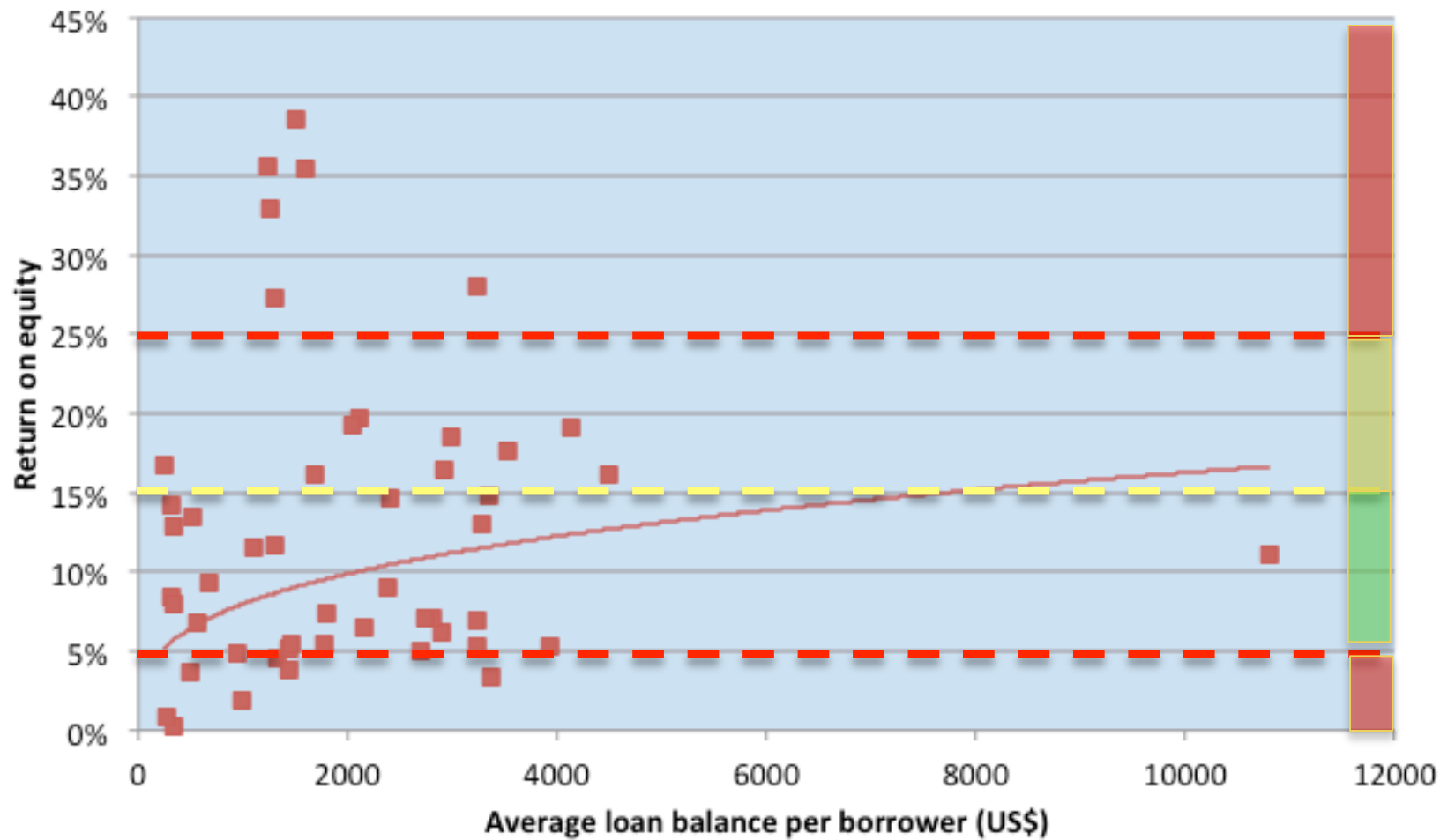
**What ROEs do we currently see?**

# Return on equity vs Average loan balance per borrower (US\$)

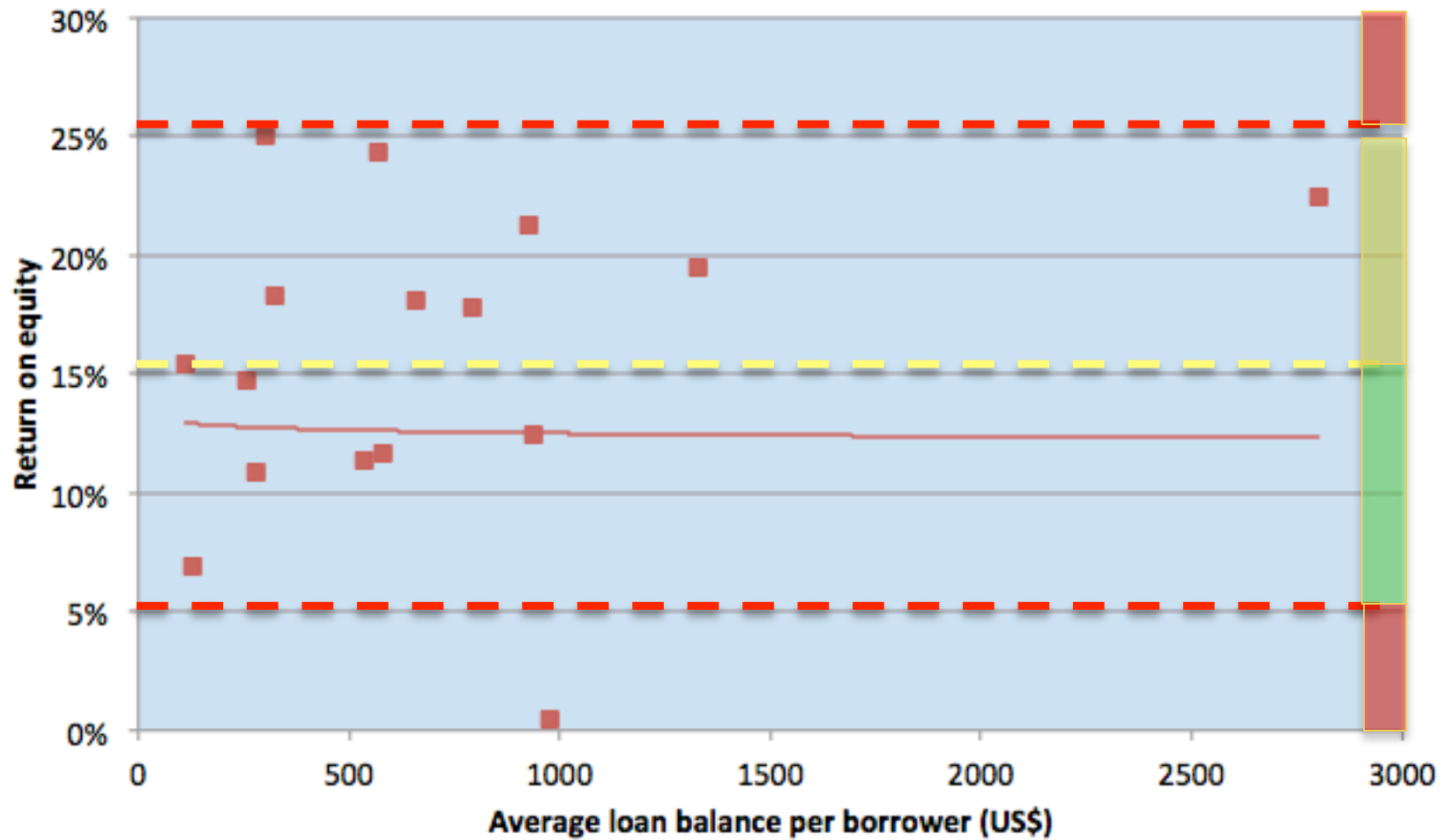
Data for 22 MFIs in Bolivia, 2010



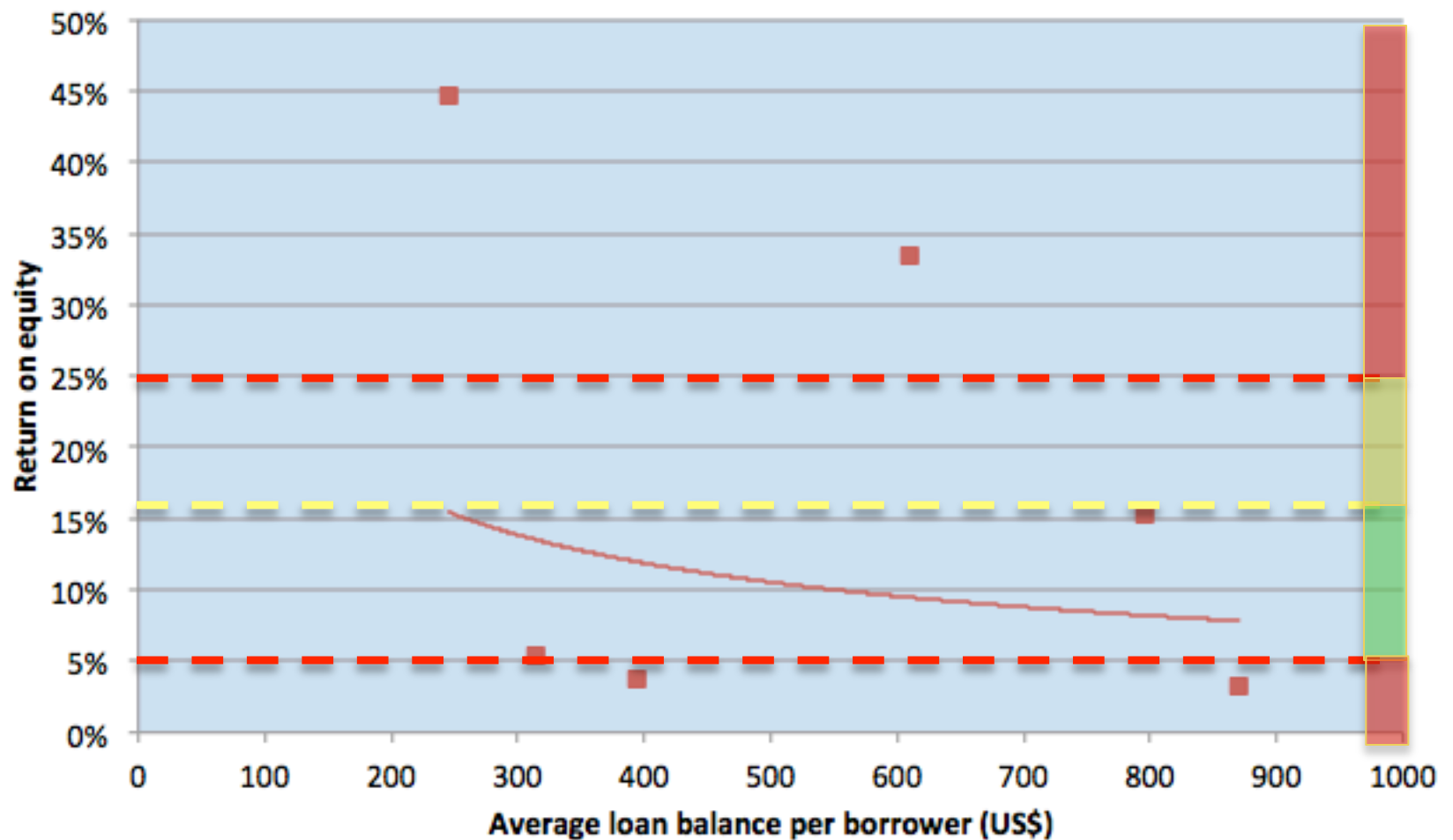
**Return on equity vs Average loan balance per borrower (US\$)**  
**Data for 51 MFIs in Peru, 2010**



**Return on equity vs Average loan balance per borrower (US\$)**  
**Data for 16 MFIs in Cambodia, 2010**

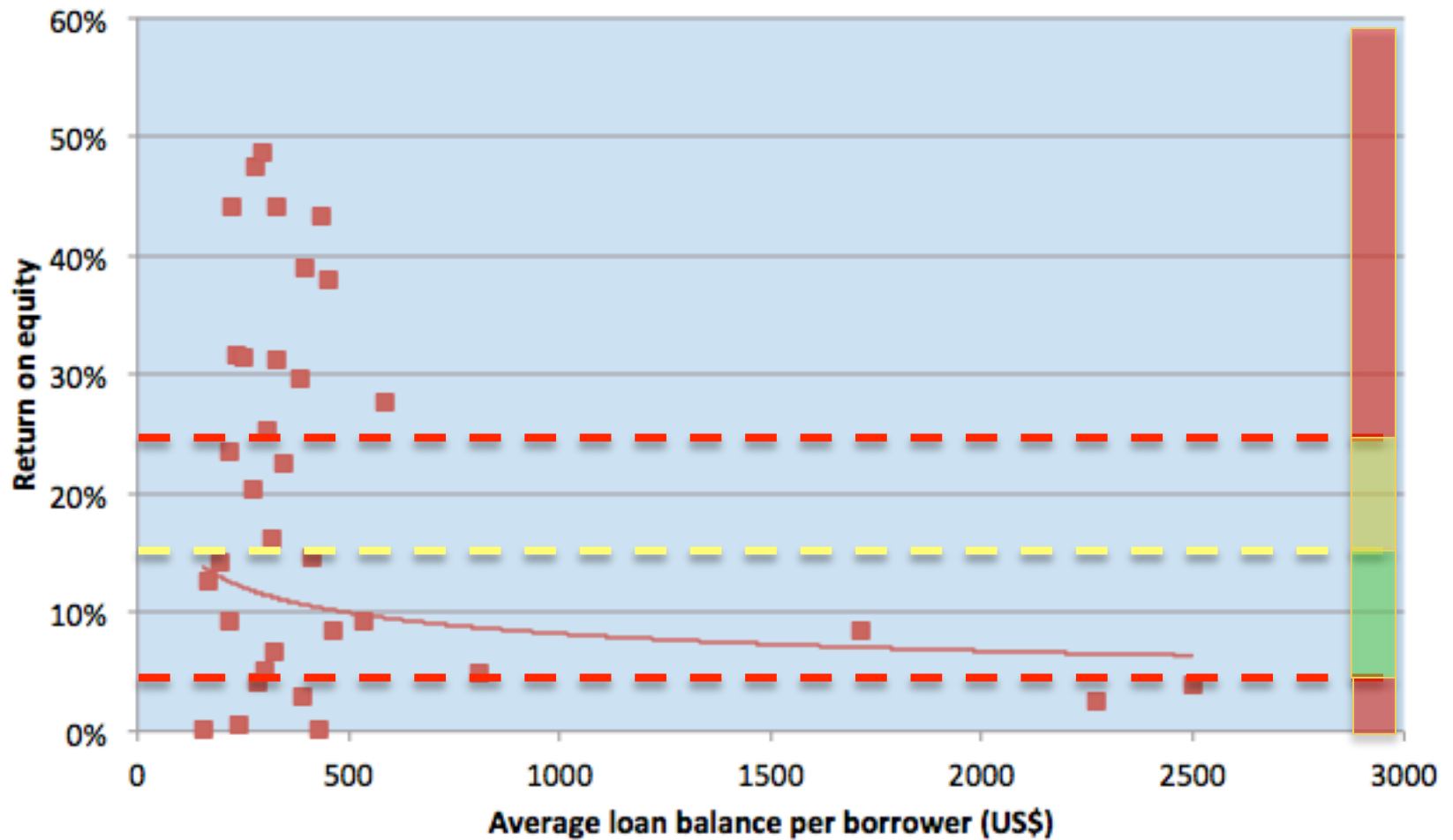


**Return on equity vs Average loan balance per borrower (US\$)**  
**Data for 6 MFIs in Morocco, 2010**



# Return on equity vs Average loan balance per borrower (US\$)

Data for 42 MFIs in Mexico, 2010



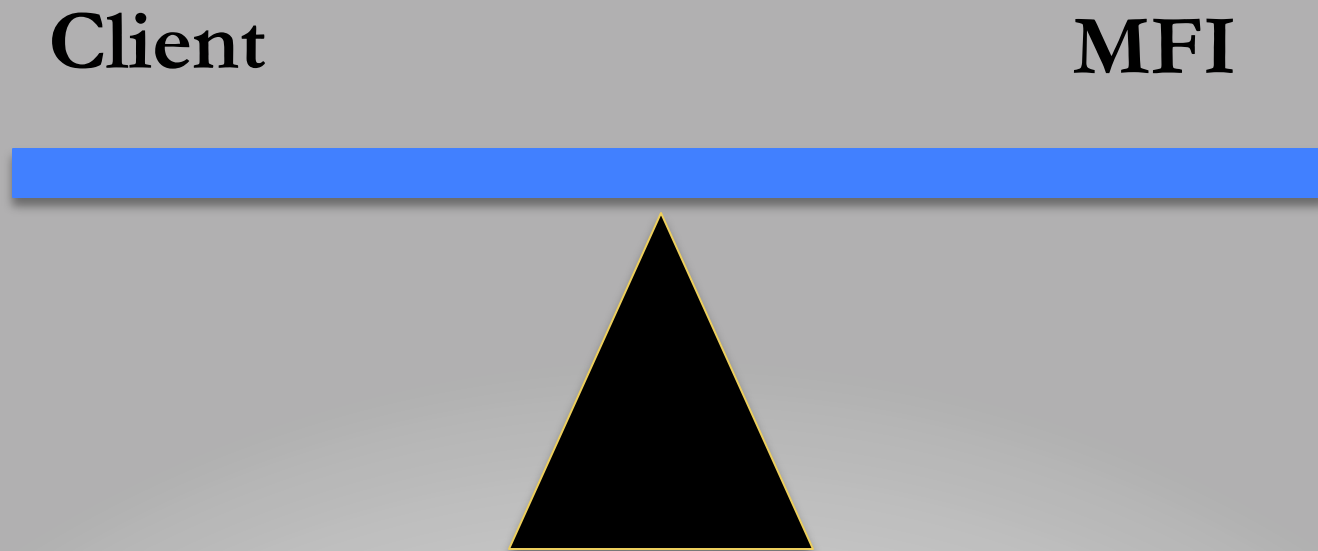
\* Negative ROEs filtered out to improve y-axis visibility



# **Profitability: Zero-Sum and Double-Bottom Line**

# Double Bottom Line –

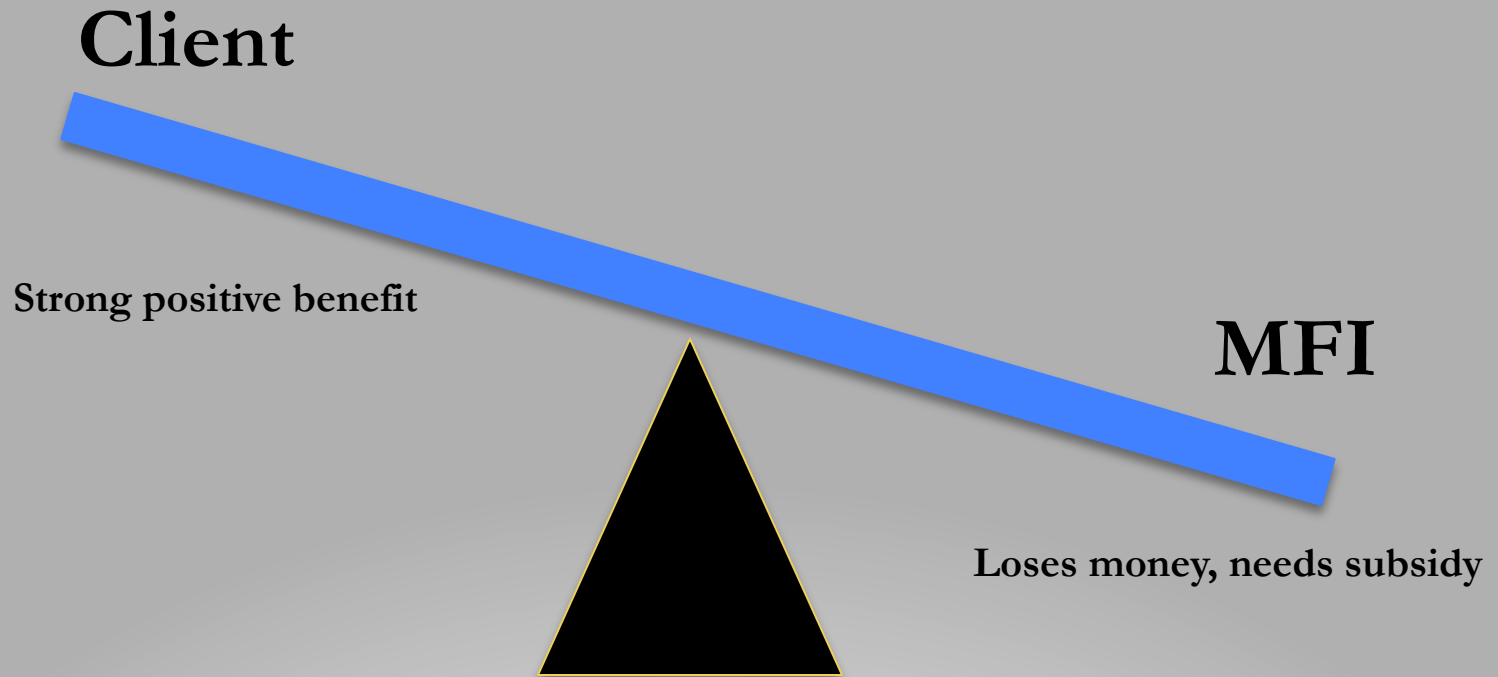
There is a balance between business and client



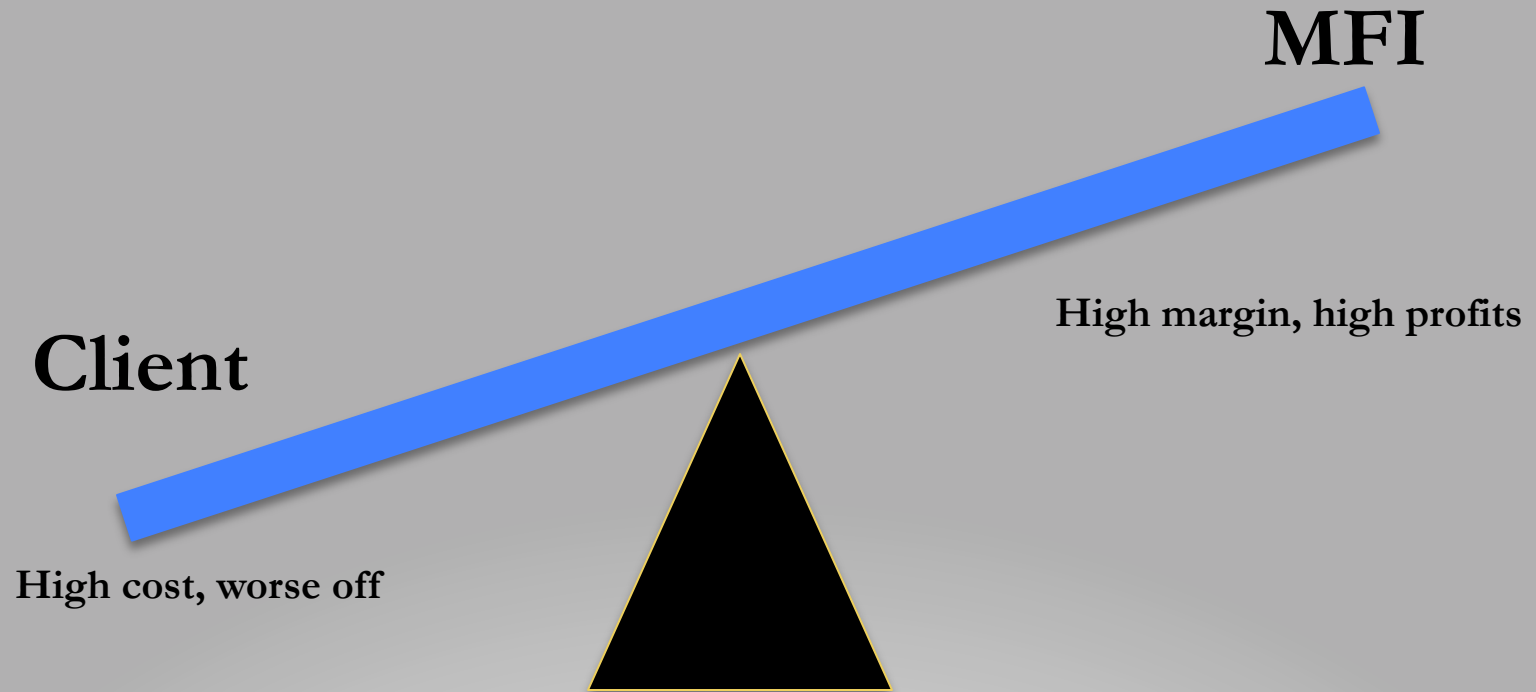
Ideally, we seek a “win-win” in which both the client and the MFI benefit

# Social Project –

## The client is given priority



# Profit Maximizing – The business exerts full power

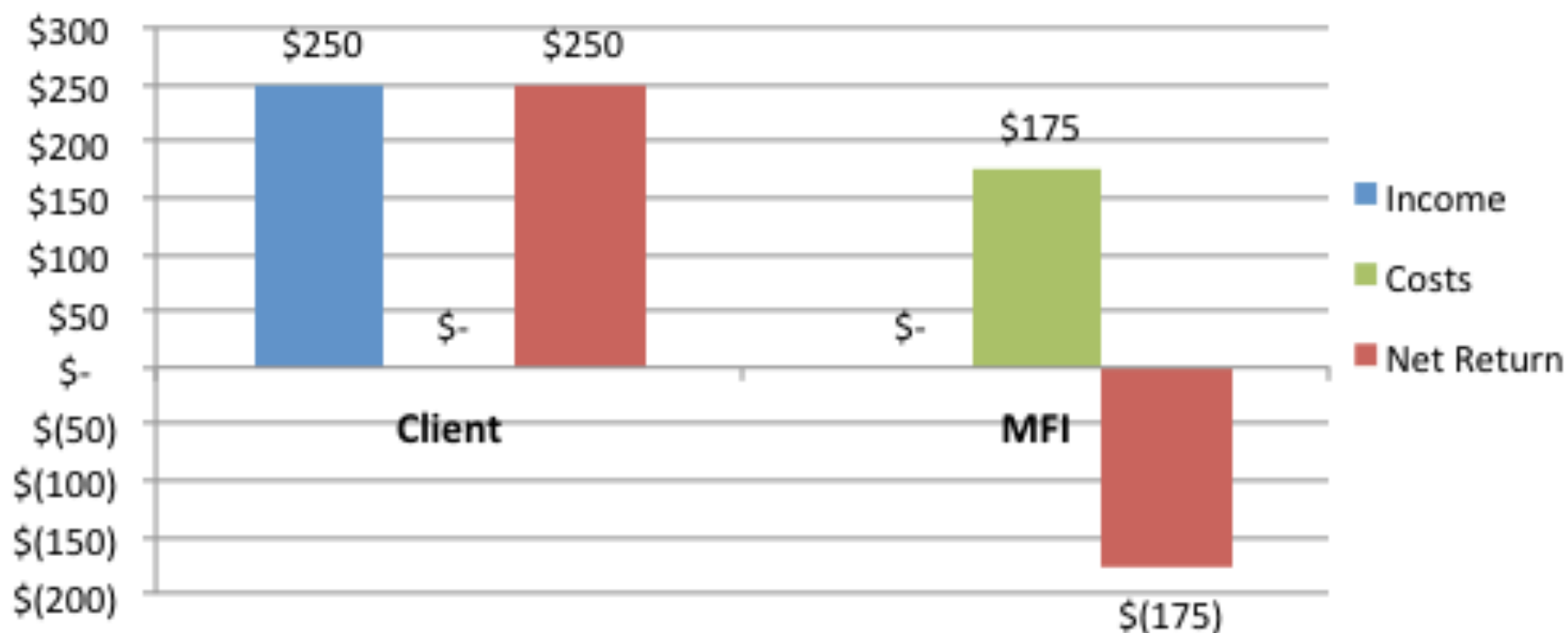


# This is a Zero-Sum Situation

## Money does not just materialize from nowhere

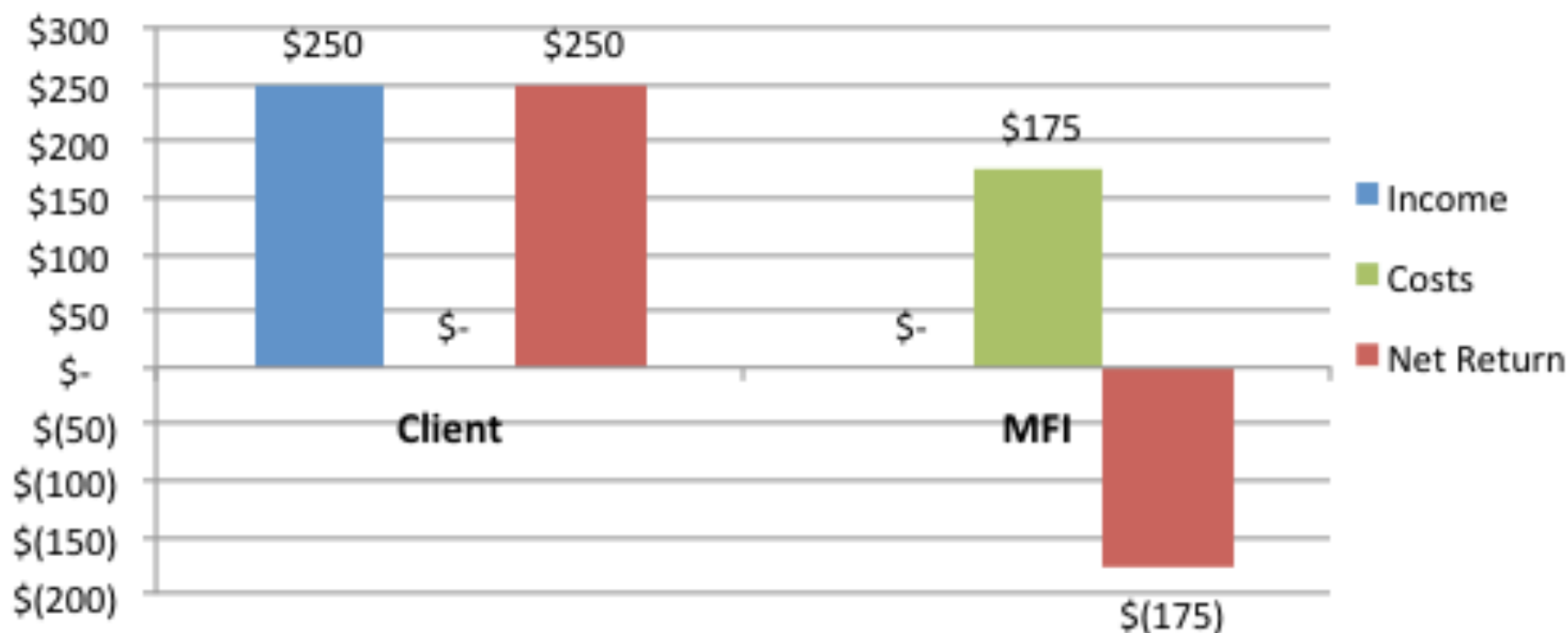
- Every penny of profit the MFI makes comes from the pockets of the clients
- Our clients are from the Bottom of the Pyramid. They are poor, and mostly female
- At some point, the MFI's profit absorbs all the economic impact the client received from the loan. The MFI's shareholders are wealthier, and the clients are poorer

## Who Benefits? A Zero-Sum Situation



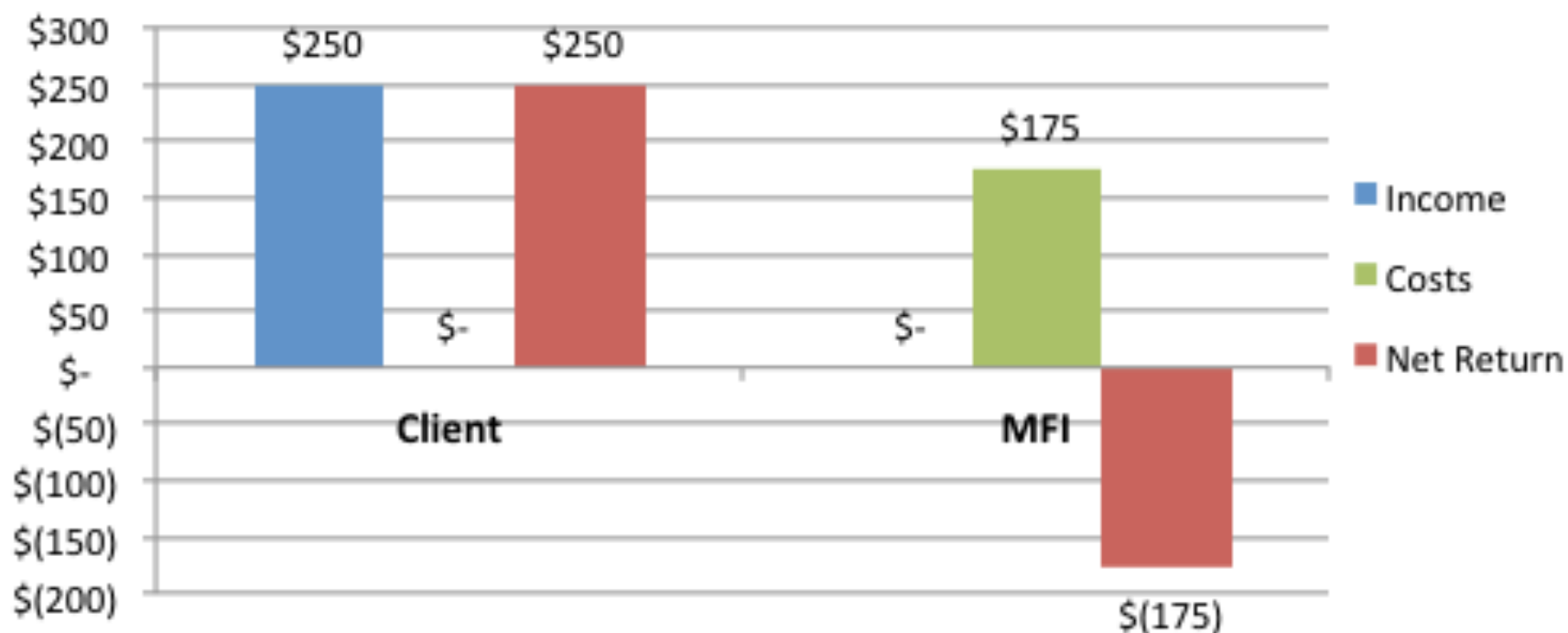
	Client		MFI		Client		MFI	
Income	ROI	APR	50%	0%	\$ 250	\$ -		
- Cost	APR	TCR	0%	35%	\$ -	\$ 175		
= Net Return	Impact	ROA	50%	-35%	\$ 250	\$ (175)		
x Leverage		EqM		3.00				
= ROI		ROE		-105%				
Breakeven	Initial Loan	\$1,000	Avg Balance	\$500	Breakeven	#N/A	years	

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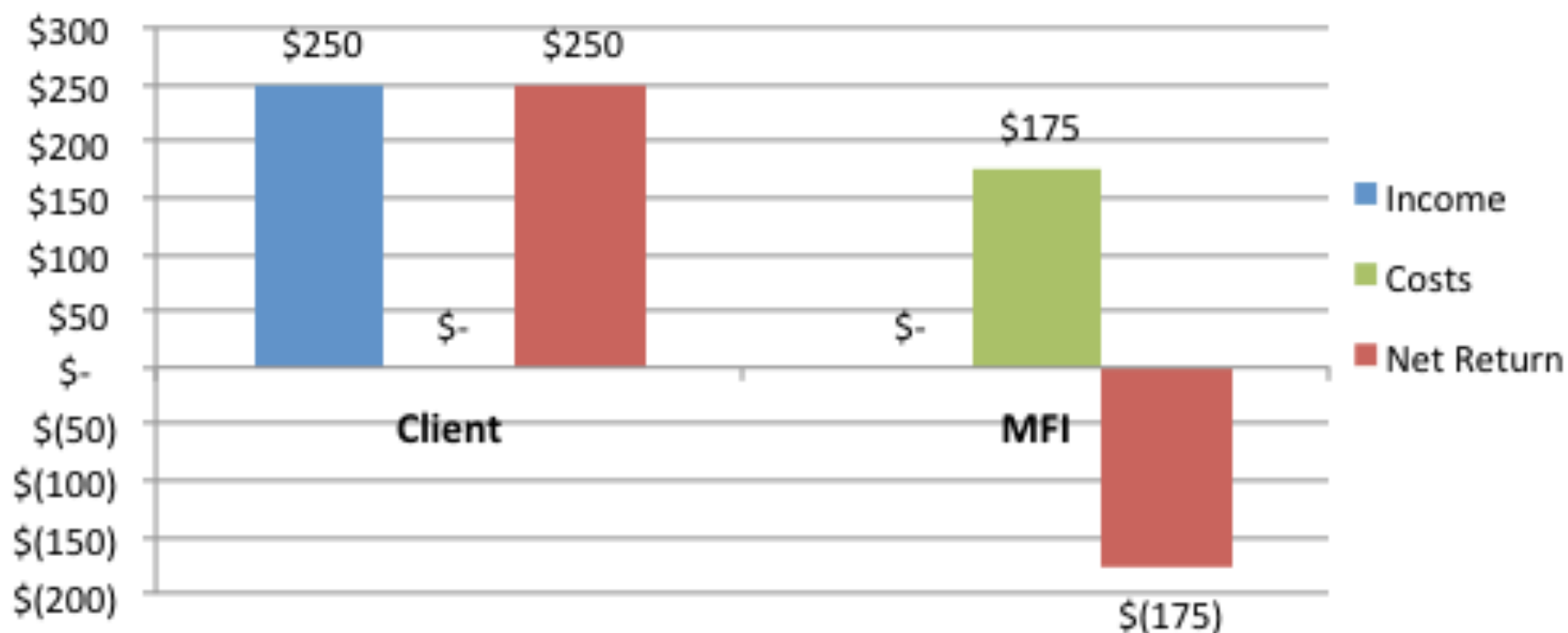
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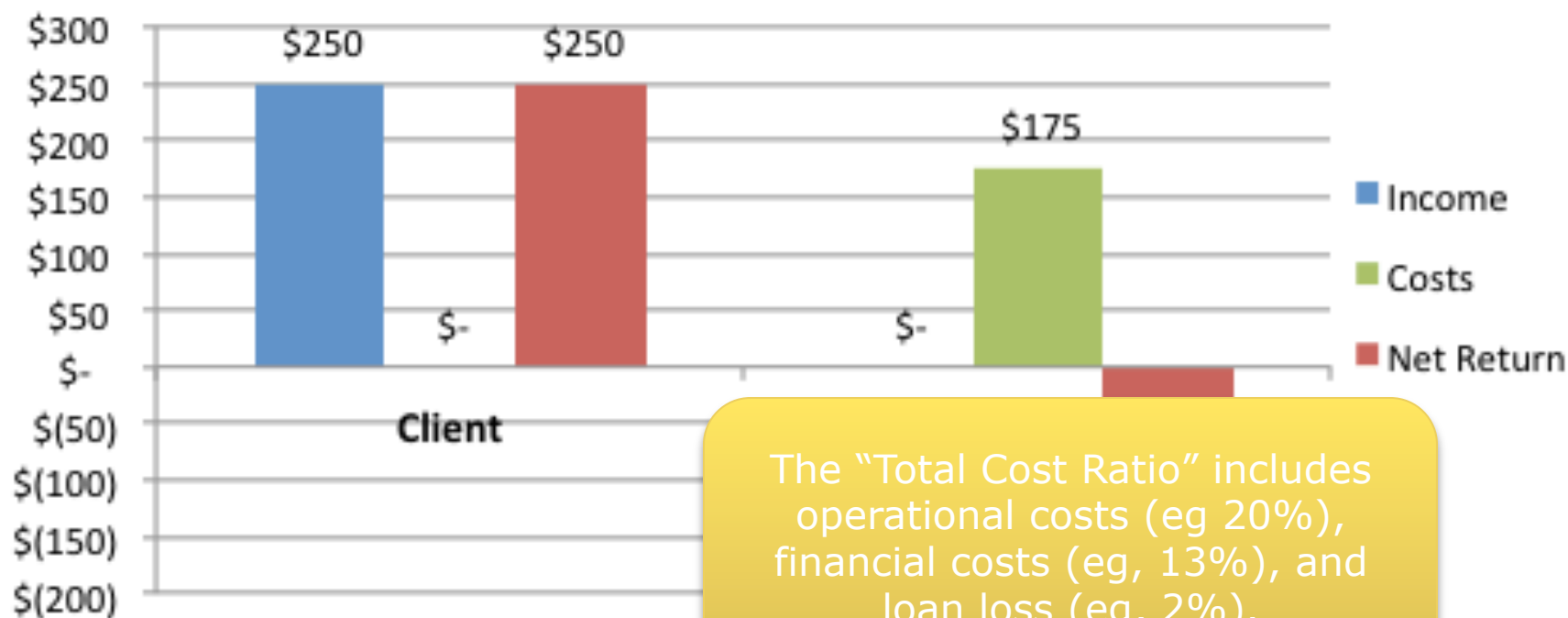


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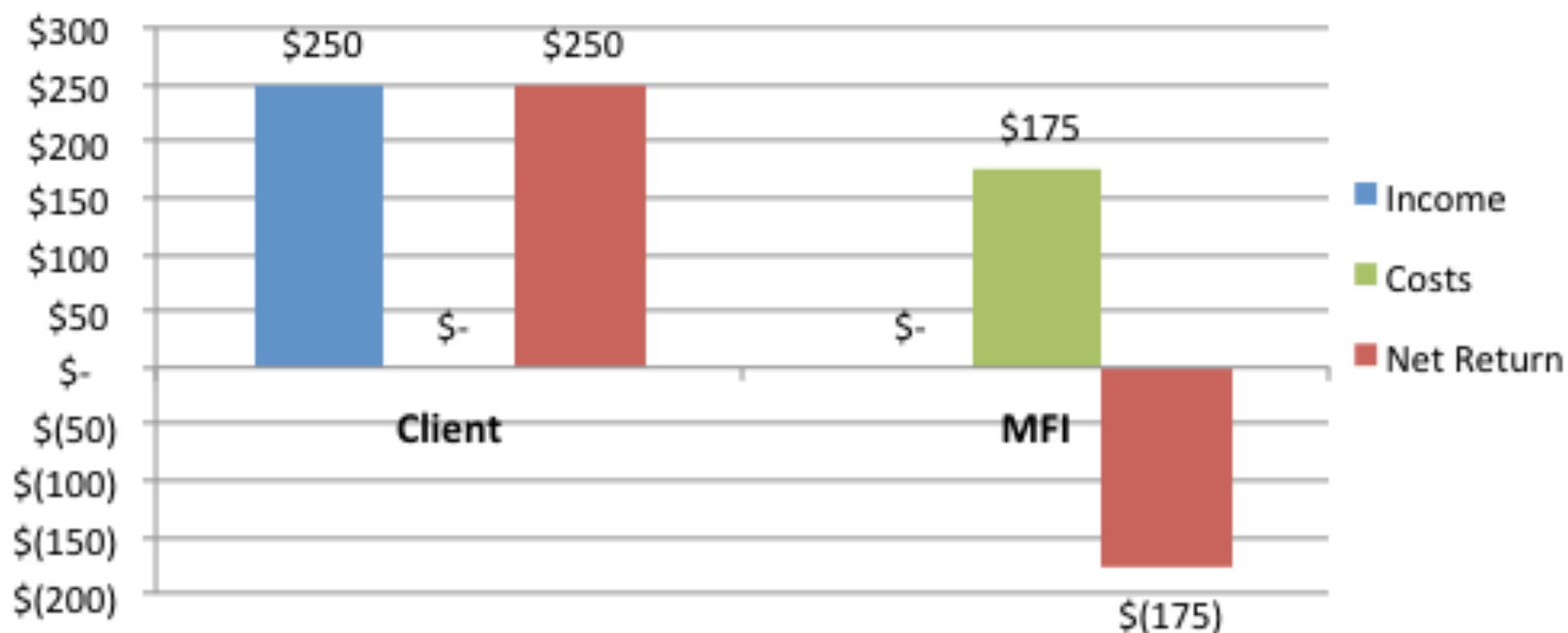
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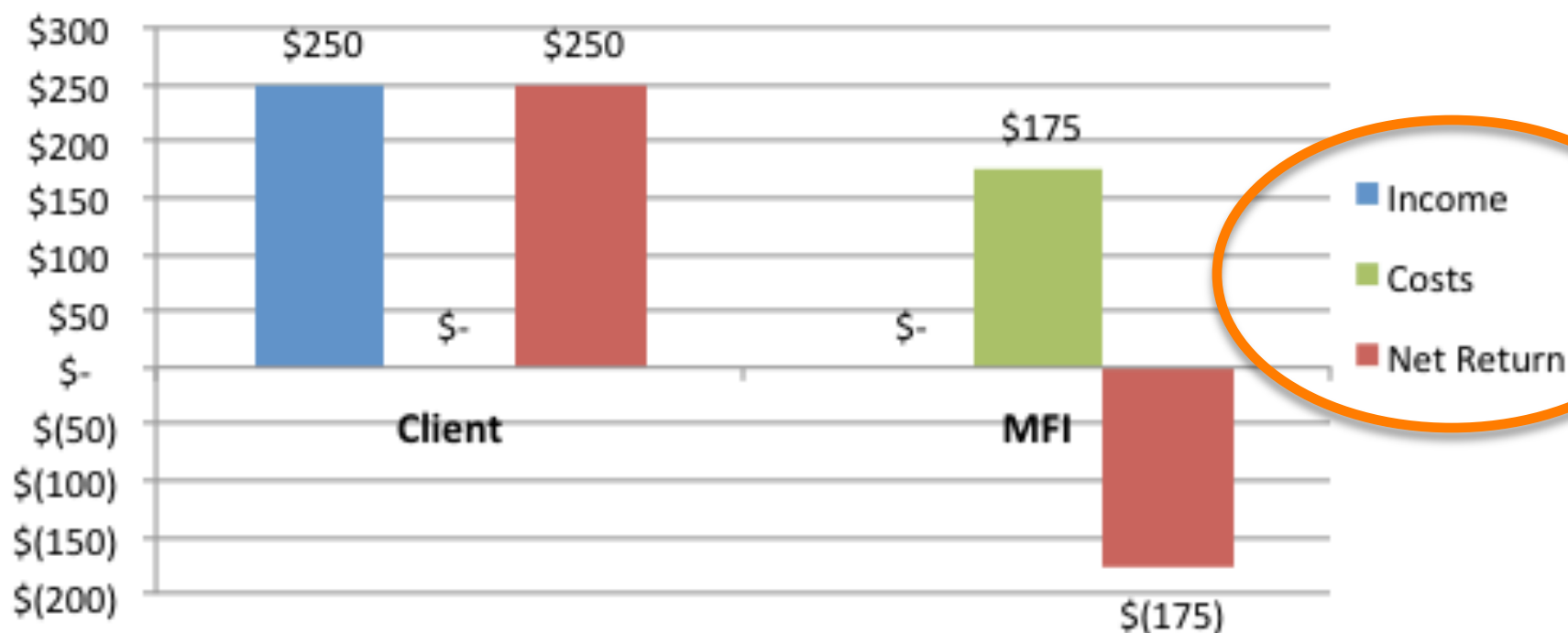
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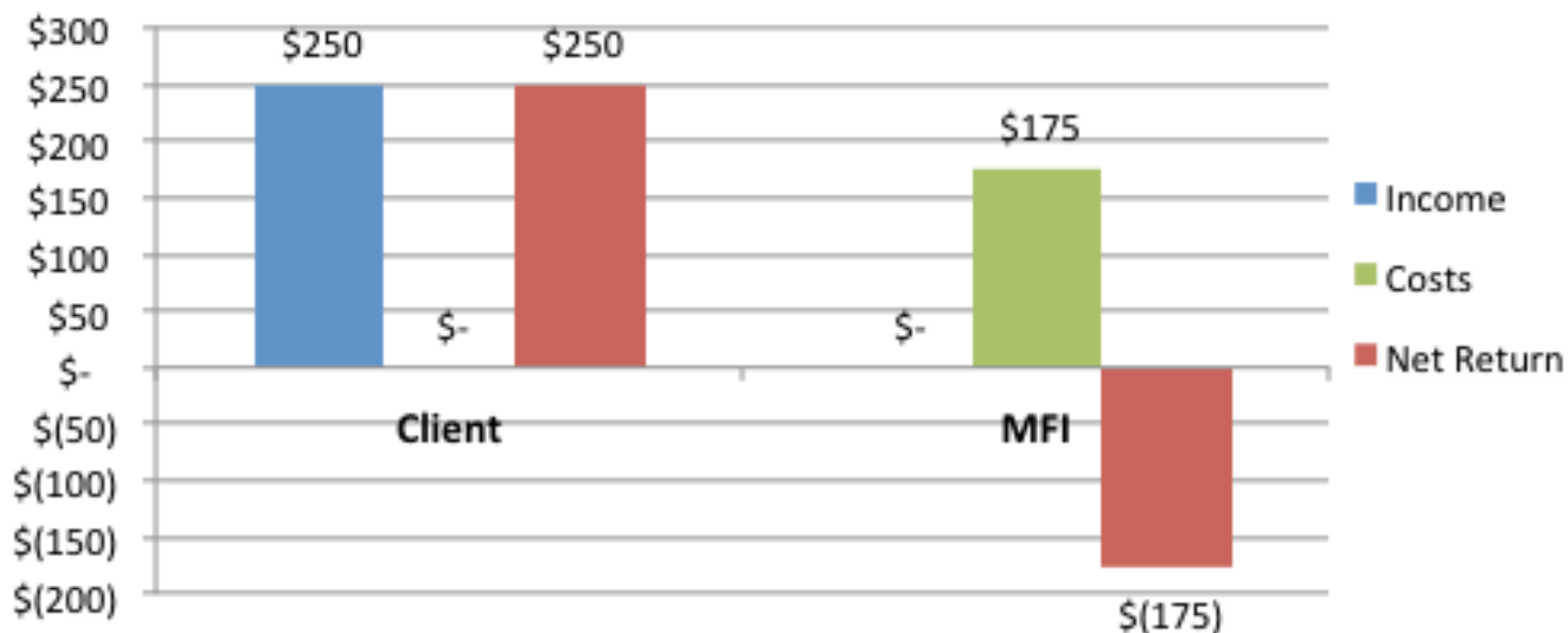
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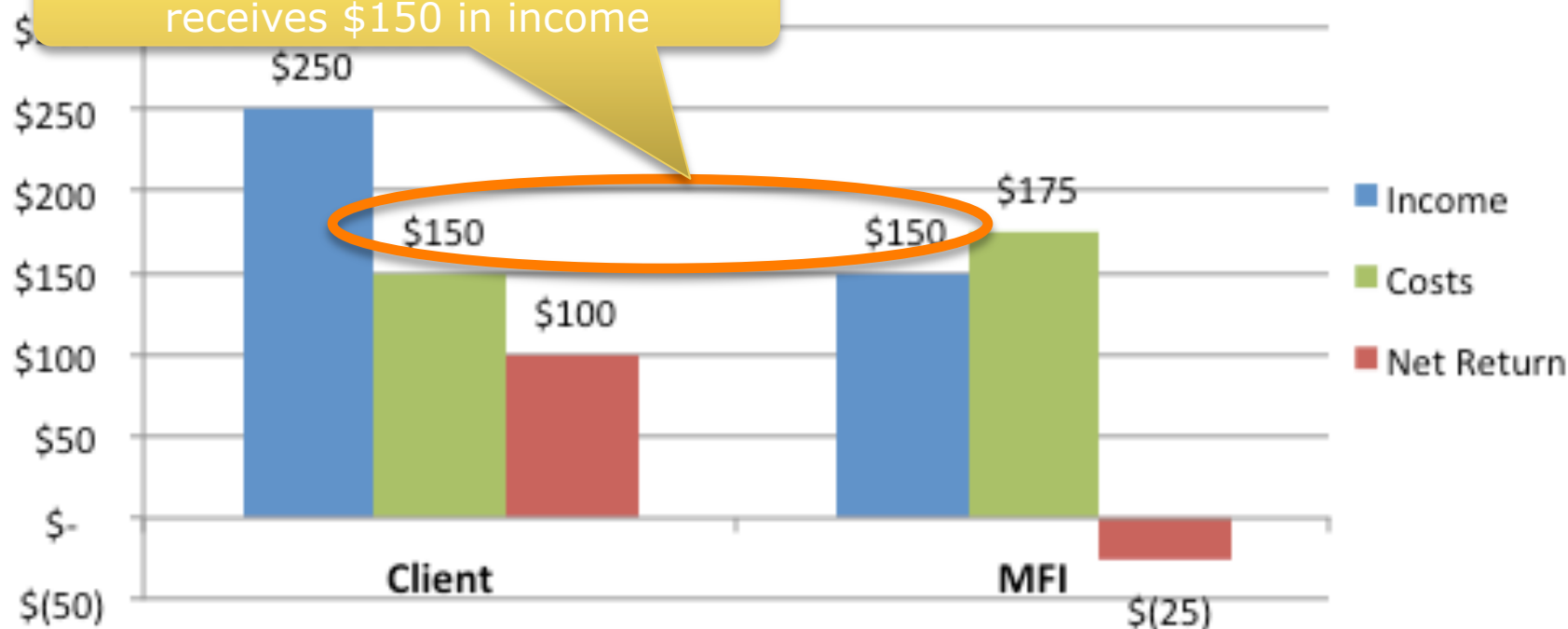


The MFI now charges a price of 30%

	Client		MFI		Client		MFI	
Income	ROI	APR	50%	30%	\$ 250	\$ 150		
- Cost	APR	TCR	30%	35%	\$ 150	\$ 175		
= Net Return	Impact	ROA	20%	-5%	\$ 100	\$ (25)		
x Leverage		EqM		3.00				
= ROI		ROE		-15%				
Breakeven	Initial Loan	\$1,000	Avg Balance	\$500	Breakeven	3.33	years	

## Who Benefits? A Zero-Sum Situation

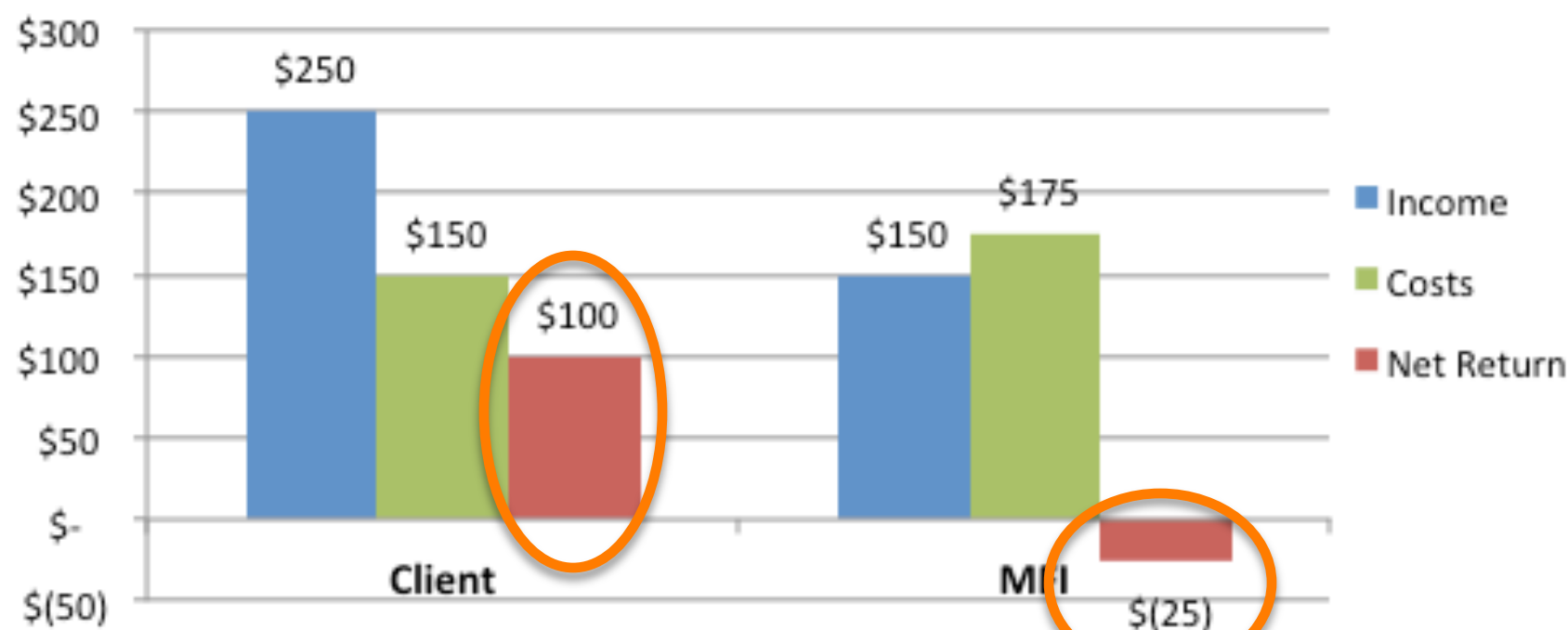
The client pays \$150, and the MFI receives \$150 in income



	Client		MFI		Client		MFI		Client		MFI	
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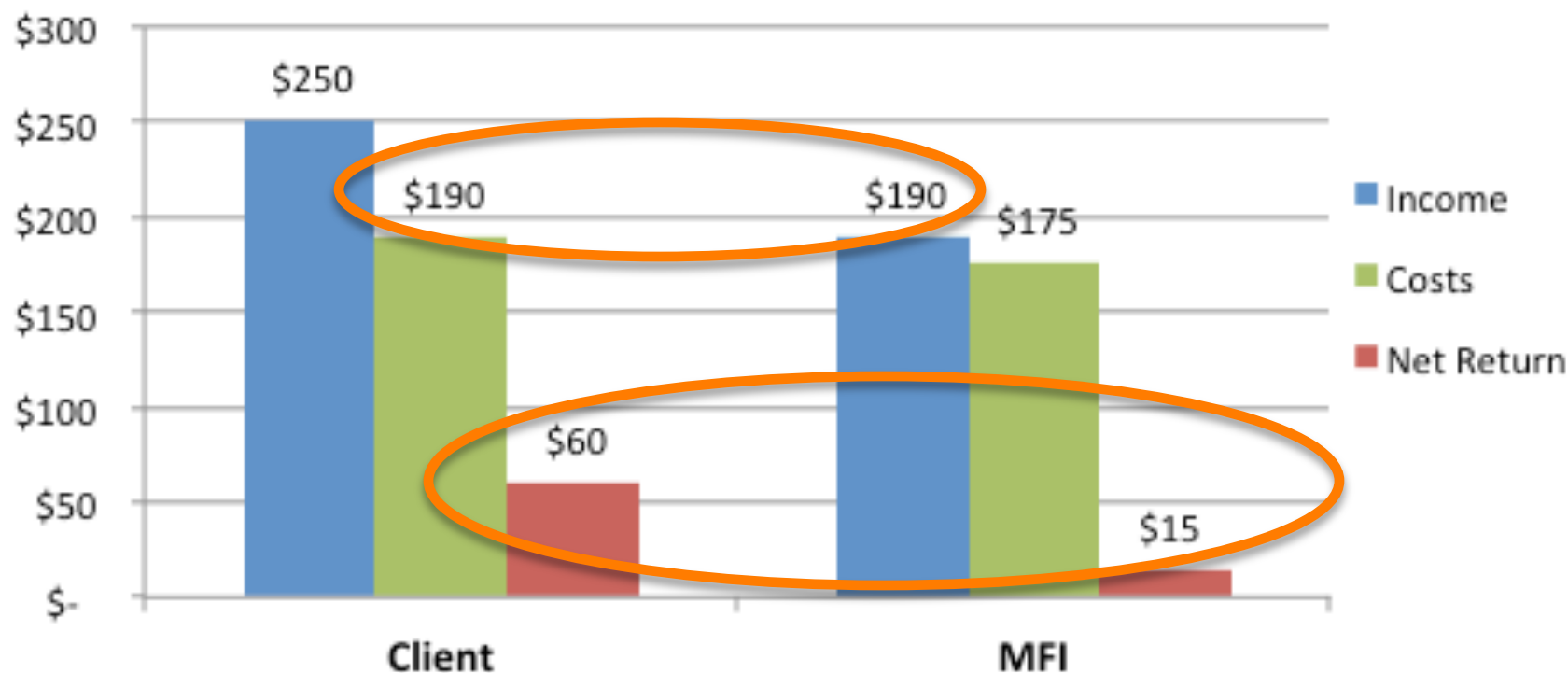


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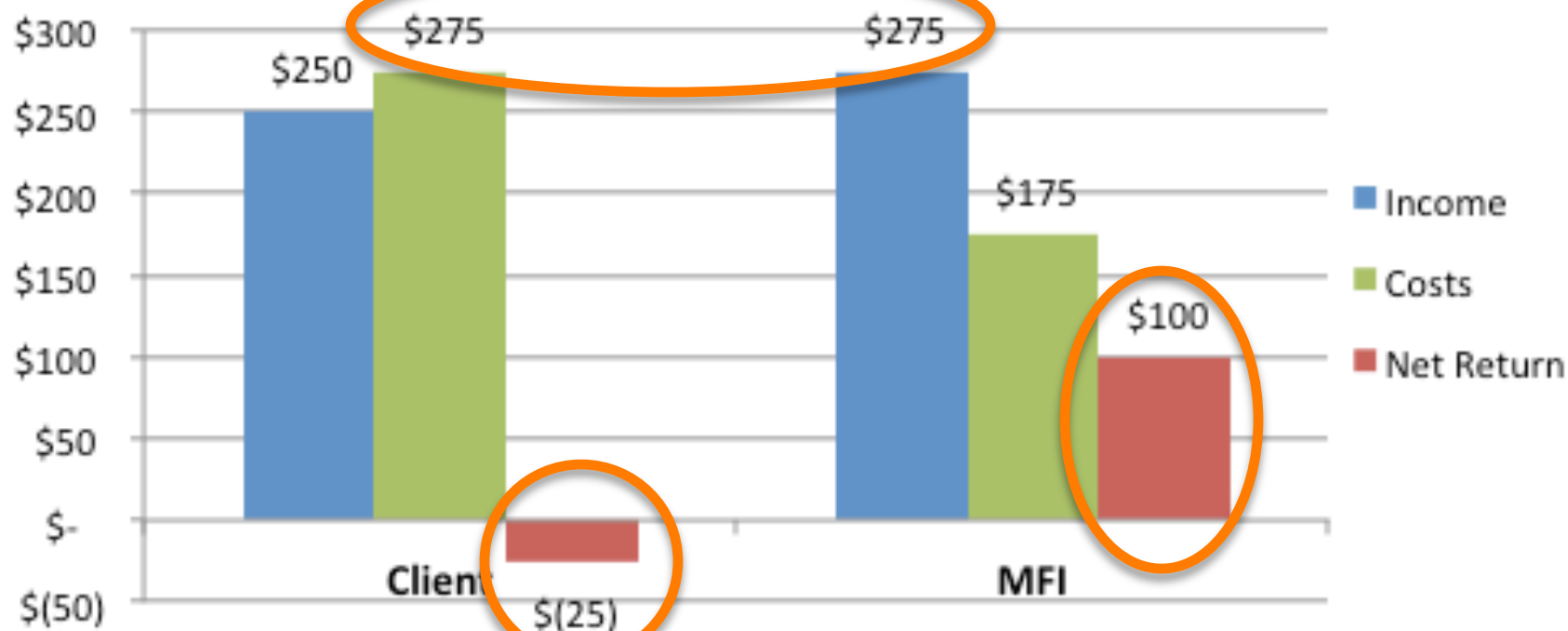
	Client		MFI		Client		MFI		Client		MFI	
Income	ROI	APR	50%	38%	\$	250	\$	190				
- Cost	APR	TCR	38%	35%	\$	190	\$	175				
= Net Return	Impact	ROA	12%	3%	\$	60	\$	15				
x Leverage		EqM		3.00								
= ROI		ROE		9%								
Breakeven	Initial Loan	\$1,000	Avg Balance	\$500	Breakeven		2.63	years				

## Who Benefits? A Zero-Sum Situation



	Client		MFI		Client		MFI		Client		MFI	
Income	ROI	APR	50%	43%	\$	250	\$	215				
- Cost	APR	TCR	43%	35%	\$	215	\$	175				
= Net Return	Impact	ROA	7%	8%	\$	35	\$	40				
x Leverage		EqM		3.00								
= ROI		ROE		24%								
Breakeven	Initial Loan	\$1,000	Avg Balance	\$500	Breakeven	2.33	years					

## Who Benefits? A Zero-Sum Situation



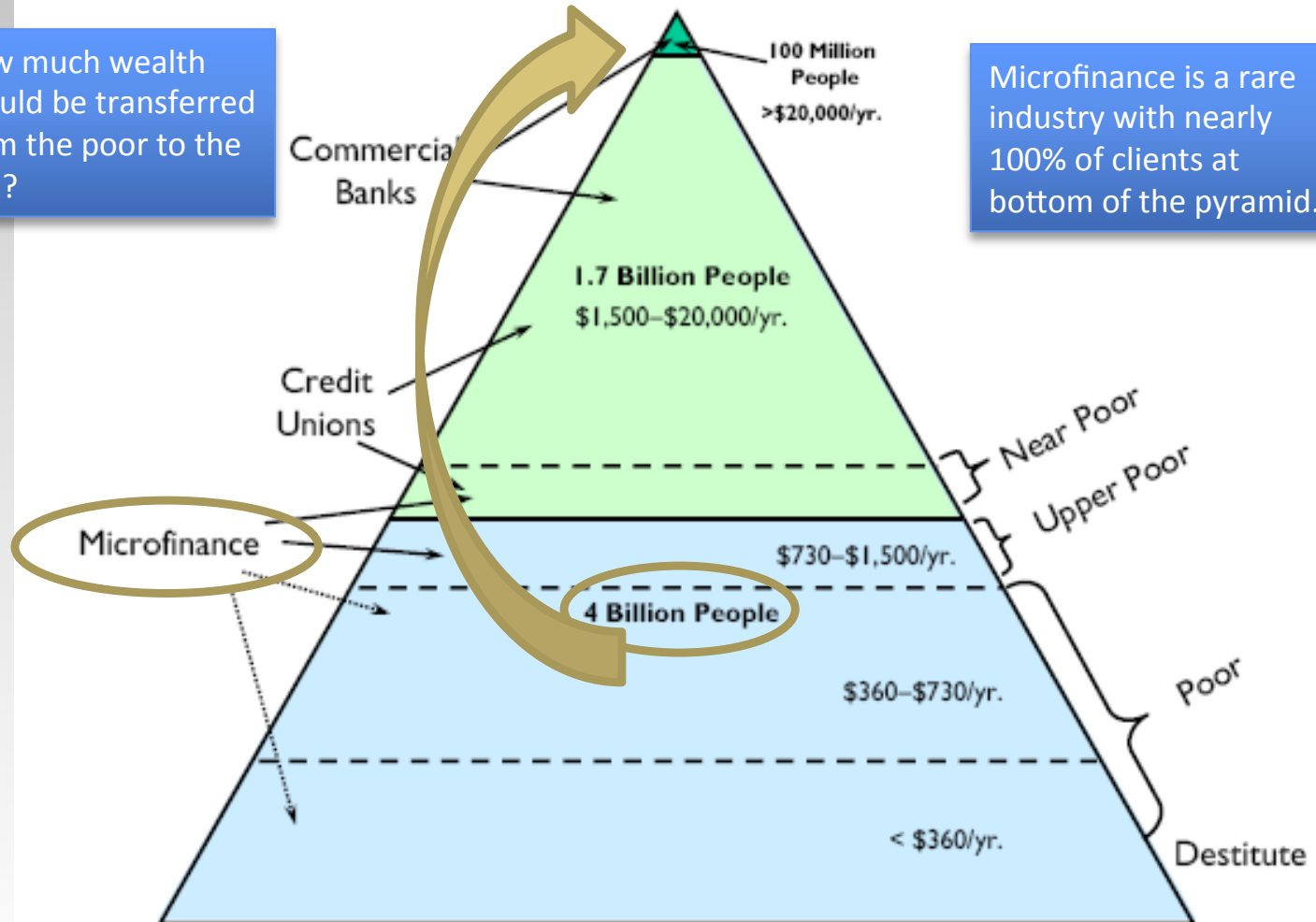
	Client		MFI		Client		MFI		Client		MFI	
Income	ROI	APR	50%	55%	\$	250	\$	275				
- Cost	APR	TCR	55%	35%	\$	275	\$	175				
= Net Return	Impact	ROA	-5%	20%	\$	(25)	\$	100				
x Leverage		EqM		3.00								
= ROI		ROE		60%								
Breakeven	Initial Loan	\$1,000	Avg Balance	\$500	Breakeven	1.82	years					

# The Income Distribution Pyramid

## Microfinance Can Reach the Lower Income Levels

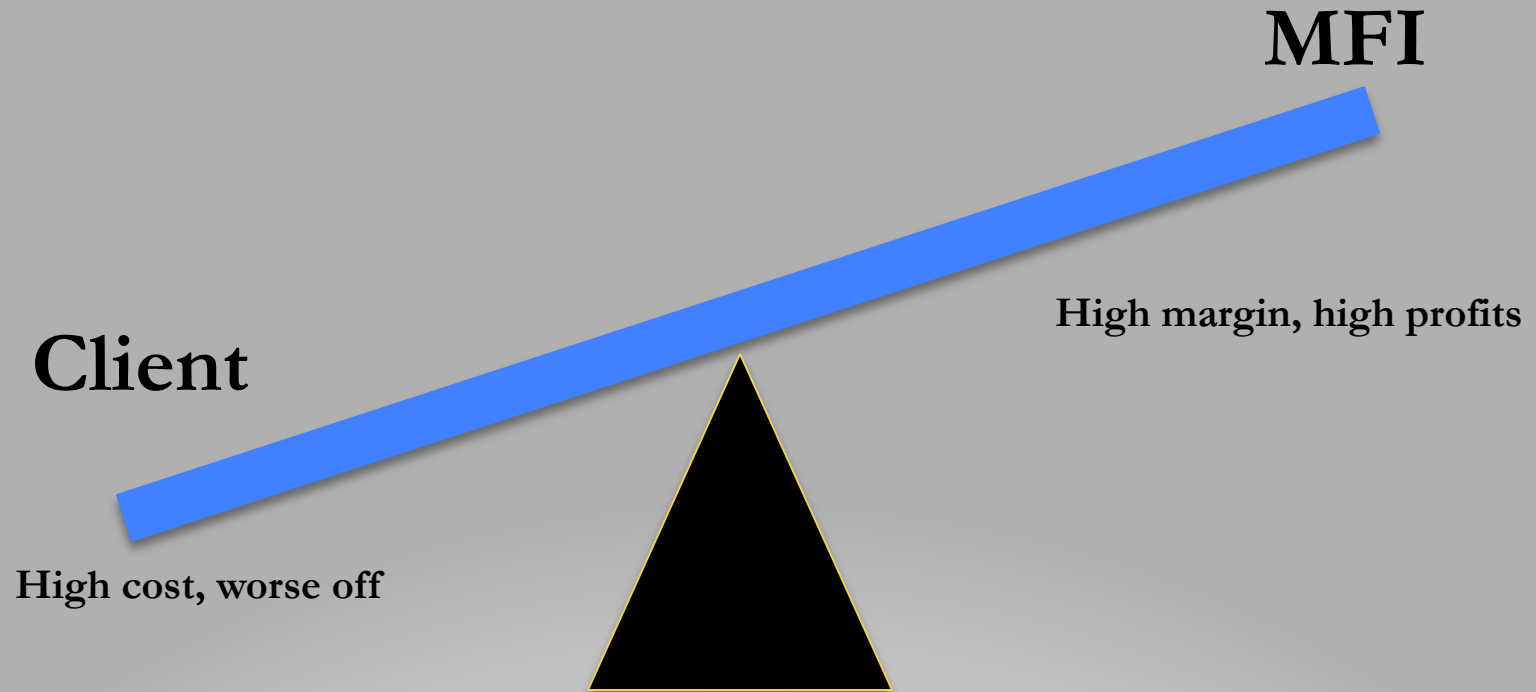
How much wealth should be transferred from the poor to the rich?

Microfinance is a rare industry with nearly 100% of clients at bottom of the pyramid.



\*Sources: VISA International, World Bank, C.K. Pralahad

# Profit Maximizing – The business exerts full power



# Prices and Profits



Compartamos	
Avg loan balance	\$372
Total Paid by her	\$333
Compartamos Profit	\$124

**Compartamos Dividends  
paid to shareholders in 2009:  
\$100 million**

**Dividends in 2010: another  
\$100 million**

The industry is dialoguing measurement of *social balance* and *responsibility*, but we are missing a key point:

We fail to set a limit: “How much profit is too much profit, when our clients are the poor?”



# A flawed approach in measuring balance

- We have complex compilations of criteria, with weightings
- After collecting all the information, we try to get a yes/no answer on “balance”
- An MFI can get high scores on many areas, such as target group and growth, but that MFI may be making extremely high profits
- The weighting system allows them to be classified as “responsible”

# Profit Should be a Threshold Criteria

- How should we distinguish between responsible practice and aggressive imperfect-market behavior?
- MFIs should have a first threshold of profit moderation
  - If they exceed the limits, they do not qualify for social business
- If they stay within the profit threshold, then they are evaluated on other social criteria
- If an MFI has a combination of responsible finance performance and responsible social performance, then they are double bottom line.

# SEEP Conference, Nov 2007

## Debate on Compartamos IPO

Many of the points I continue to raise now, such as those in this presentation, are consistent with my first panel debate on the Compartamos IPO in November 2007. Some excerpts:

*Compartamos has pushed well beyond the self-restraint that the majority of us in the industry respect. And now that the boundaries have been breached, I fear we are at a moment when microfinance could be taking a significant change in course. I firmly believe that we in the microfinance community need to protect the poor from this style of profiteering. We have focused for the past two decades on how to “get financial services to the poor”. But we now need to add on a companion focus: how to “protect the poor from ourselves”.*

# SEEP Conference, Nov 2007

## Debate on Compartamos IPO

*Compartamos tells us that this is the “future of microfinance.” For six months, I’ve honestly been trying to find a distinction between this approach I’ve just described and what moneylenders have been doing for centuries. Sadly, I’ve not yet come up with any significant distinction. We are progressively and rapidly blurring the lines between microfinance and moneylending.*

*To counteract this radical shift from the middle-ground of “social business” to profit-maximizing commercialism, I believe we need to move actively and even aggressively toward goals of increased **institutional transparency** and establishing serious **consumer protection efforts**.*

# SEEP Conference, Nov 2007

## Debate on Compartamos IPO

*Recently I heard a quote from the Jewish theologian Rabbi Abraham Heschel that ends with the following:*

***“Only some are guilty, while all are responsible.”***

*I’ve been thinking about that perspective in relation to this issue. We in this room may not be guilty, but I think we should all feel responsible. This happened in our industry, with our support and our personal and professional investments. And it will happen again. We are not guilty, but we **are** now responsible to make efforts to restrain the negative impacts that our industry can and will have on the poor.*

***“Only some are guilty, while all are responsible.”***

***Abraham Heschel***



# Promoting Transparent Pricing in the Microfinance Industry

MicroFinance Transparency is an NGO registered in the USA

