

*NICARAO: Transforming a Non-Profit Microfinance Organization*¹

Managua, Nicaragua

The Flight

Chuck Barrett, a successful New York investment banker who retired to manage a social investment fund targeted at developing countries, fastened his seat belt and organized his reading materials for the six-hour flight from New York to Managua, Nicaragua. He would be visiting a non-profit microfinance foundation called *Nicarao*, one of Nicaragua's top programs providing credit to micro-entrepreneurs in Nicaragua's informal sector. As an analyst for *ProDev*, a social investment fund focused on developing country projects, he was to evaluate a potential investment in *Nicarao* which served over 6,000 small micro-entrepreneurs working in poverty conditions. As Latin America's poorest country in the wake of the disastrous Hurricane Mitch, Nicaragua was a prime candidate for *ProDev*. Furthermore, *Nicarao* was in the midst of an exciting transformation to convert from a non-profit organization to Nicaragua's first regulated financial institution catering to micro-entrepreneurs. This transformation was critical to securing additional funds from commercial sources to expand client outreach and increase *Nicarao*'s long-term viability as a permanent financial institution serving the Nicaraguan poor.

As Chuck fumbled through his papers from *Sprout*, *Nicarao*'s Christian parent organization, he began organizing details of the transformation and the proposed ownership structure if his firm takes an interest in the organization (see [Exhibit 1](#)). *ProDev* would like to consider a \$300,000-500,000 investment in either debt or equity with no timing pressure on repayment or dividends. The investment could come pre- or post-transformation so long as it was within the upcoming year (forecasted completion date for the transformation was six months).

As opposed to most other Latin American microfinance transformations that transformed directly from a non-profit to a regulated intermediary, *Nicarao* planned to merge with an existing regulated finance company. As engineered by (1) *Sprout*, its parent, (2) a multilateral bank, which was financially supporting the transformation, and (3) *Catex*, the Dutch consulting firm hired to steer the transformation, *Nicarao* would first merge with *FinNic* ("Financiera Nicaragua"), one of Nicaragua's two finance companies. *FinNic*'s owners already had an investment in a microfinance institution that would merge with *Nicarao* to form a new entity called "ServiMicro." As one of Nicaragua's two types of regulated financial institutions (commercial banks and finance companies – see [Exhibit 2](#)), *FinNic* already had a regulated charter and customer deposits that would complement *Nicarao*'s microfinance loan portfolio.

Since *FinNic* had decided to shift its primary focus to microenterprise, the two parties appeared to make a good match. *Nicarao* had the longstanding microenterprise expertise and sound portfolio, but lacked savings deposit capabilities as an unregulated entity. *FinNic*, on the other hand, had saving deposit capabilities and larger funding sources, but a limited knowledge of microfinance through its affiliates. *FinNic*'s operations were concentrated in the capital Managua, whereas *Nicarao* had a national network of 10 offices. (*Nicarao* branches are listed in [Exhibit 3](#) and the towns appear in the map in [Exhibit 4](#).) *FinNic* was interested in expanding its involvement in microfinance based on several factors: informal microenterprises accounted for the vast majority of Nicaragua's businesses, competition for traditional medium-large enterprises had become intense among commercial banks and finance companies vying for the same business, and microfinance interest rates were

relatively high so a merged entity with potentially lower operating costs could be very lucrative. It remained open whether the merged institution would retain FinNic's finance company status or seek a commercial bank charter.

As Chuck sketched out his list of key considerations, his neighbor on the plane peered over his shoulder and then introduced himself. He was a Nicaraguan lawyer living in Miami for the past 15 years. He was helping Nicaraguans who had fled to Miami during the 1980's civil war recoup their properties that were confiscated during the Sandinista regime of 1980–1989. He was curious about Chuck's social investments and the proposed institution. He was also highly anti-Sandinista, and a bit suspicious of the investment strategy. "Just be careful, my friend. It smells to me like there may be an element of Sandinista involvement here, and they're not to be trusted in financial affairs after ruining our country's businesses and economy during their regime." He pointed out that some ex-Sandinista officials owned FinNic and that most non-profit organizations started in Nicaragua had Sandinista roots. Despite Nicaragua's last ten years of democracy, stabilizing economy, and increased foreign direct investment, Chuck realized that the country was still economically distraught and that the party polarization between the Liberals (the current government, which supported economic reform and the Washington Consensus formula) and the Sandinistas remained significant, despite the significant improvements that had been made since 1989 in their reconciliation. He was not sure whether this lawyer was an extremist stemming from his personal experience as a wealthy Nicaraguan who lost assets during the Sandinista period, or whether he was speaking rationally about the real management risks of the proposed entity. In any case, Chuck decided to make a mental note to investigate the background and motives of the management teams and raise these concerns with Sprout.

Once on the ground, Chuck headed out of the airport and grabbed a taxi to his hotel. It was a beat-up Lada taxi, the old Russian-made vehicles that still dominated Nicaragua's taxi fleet. En route, he was impressed by Nicaraguans' resourcefulness in keeping this skeleton of a car on the road – the driver used rubber cords to strap the trunk shut, replaced the missing floorboard with a fresh slab of wood. He lowered his window using a wrench as a substitute for the missing knob. Mixed with the shiny new Jeeps and old American school buses used for public transit, the rattling Ladas made a lasting imprint on a visitor dramatizing the large income gap between rich and poor.

Chuck settled into the historic Hotel Intercontinental, a Taiwanese-owned hotel that was one of the few buildings surviving the 1979 earthquake and that served as a home to foreign journalists covering Nicaragua's civil war in the 1980's. This impressive and luxurious hotel recently created Nicaragua's first shopping mall, with modern movie theaters, food courts, and Miami-style shopping. Two barefoot children stood outside the building, waddling through the middle of traffic, selling water, candies, cigarettes, desk lamps, electric cords and array of other wares hanging from their shoulders. Across the street was a stockpile of road bricks and a burnt tire. The driver explained that these were vestiges of the city's transportation strike that had recently ended but things were improving as the government and drivers had just negotiated an agreement.

Chuck had a busy and interesting week ahead with Nicarao officers and he snuggled in for the night in preparation for the next day's staff meeting. He had one week to become familiar with Nicarao's operations, meet the Nicarao and FinNic management teams, meet with the Catex consultants, and visit contacts in the development agencies in Managua. Prior to investing, Chuck had to evaluate the institution's operations, interact with personnel at all levels, approve the investment strategy, ensure the protection of principal, interview the new management team and consultants and, most importantly, visit the clients who were at the heart of ProDev's potential investment (see

Exhibit 15). It seemed unlikely that during this visit he would have sufficient time to take up tempting tourist activities like hiking up one of Nicaragua's 70 volcanoes.

The Special Staff Meeting

At 9:00 am Sunday morning, Chuck arrived for his first event. All of Nicarao's employees had gathered for a special staff meeting at a local Managuan conference center. The microfinance institution had grown noticeably in recent years and after three years of research and contemplation, Sprout decided to move ahead with Nicarao's transformation from a non-profit foundation to a regulated finance intermediary. This was the goal of most successful microfinance institutions ("MFI") that were financially self-sustaining like Nicarao. The Dutch consultant team, Catex, had just arrived the previous week to help launch the implementation of the transformation. Catex had an impressive track record leading Latin American MFI transformations and had been contracted by Sprout with partial funding support from a multilateral development bank. Catex would

evaluate Nicarao's two options for becoming a regulated finance institution: either become a commercial bank or a "financiera" (or finance company, contrasted with banks in [Exhibit 2](#)). They would install a new management information system to serve its needs.

The purpose of the special staff meeting was to: (1) formally present the transformation strategy to Nicarao's staff, and introduce the Dutch consultants who were to guide the effort (rumors about change had circulated for months at the regional offices), and (2) review the consistency of operational procedures and accounting practices at the recently decentralized offices. Additionally, the meeting provided an opportunity to introduce the new staff from Nicarao's 10 branches ([Exhibit 3](#)) and work with them on team building. The full agenda called for strong Nicaraguan coffee, which was in ample supply throughout the day. Chuck refilled his cup as he prepared for a day of listening to presentations, gaining insight into management, and conversing in his broken Spanish with Nicarao's employees.

The General Manager and the Transformation Strategy

Marta, the General Manager, kicked off the morning with an excellent synopsis of Nicarao's history. She noted its social economic roots of providing credit and training to micro-entrepreneurs to increase their business income and employment in the early 1990's, the government's transition from the Sandinistas to democracy and the beginning of market reforms. The 1980's had been an economic disaster for Nicaraguans. Economic mismanagement by Nicaraguan political leaders and the economic embargo by the U.S. had constricted the economy, resulting in hyperinflation, unmanageable external debt, and serious unemployment. (See background on Nicaragua in [Exhibit 5](#) and economic indicators in [Exhibit 6](#).) Even today, following the return to a market economy, Nicaragua's GDP remained below its 1979 pre-revolution level. The large external debt and the weak economy resulted in a large informal sector where many of Nicaragua's poor survived only through self-employment opportunities. Nicarao's objective was to help these small micro-entrepreneurs prosper by providing them credit and training services.

Marta spoke of Nicarao's growth and progress to-date, highlighting the need to upgrade its institutional structure to accommodate the transformation strategy. The transformation should increase Nicarao's funding sources and client outreach both numerically and geographically by opening new offices. Additionally, it offered good

prospects for expanding its product offerings with savings accounts and new finance products. To implement this goal, Nicarao needed a strong MIS to manage its growing portfolio, lower its high operating costs, and improve operating efficiencies so that loan officers could meet new customer load targets – double Nicarao's current norm – and expected to triple over the next five years. The lack of strong MIS had not only resulted in recurring mistakes in manual interest calculations but also a time consuming monthly reconciliation process to match Nicarao's internal accounting with loan portfolio records. More than anything else, local office accountants dreaded this two-day reconciliation process which could be eliminated with a proper functioning MIS.

Catex Consultants

Hans and Erik, the transformation and systems specialists from Catex, then gave a brief introduction to Catex's qualifications as an international MFI consulting group. At Nicarao, they would offer a package of services: (1) MIS installation combined with credit technology changes; (2) training of office staff in new credit procedures and MIS changes; and (3) specialized advisory work on Nicarao's transformation with the Nicaraguan Bank Superintendent. Sprout and the multilateral bank were financing this "overhaul" and had contracted with Catex to work with Nicarao for the next year on these specific projects. Hans and Erik outlined the training implementation, highlighting that it would be rigorous and condensed into six months due to time constraints for presenting the transformation application to the Banking Superintendent. It was also likely that FinNic would sign a long term contract for a Catex information system specialist who would design the appropriate reporting required of regulated institutions and manage ongoing MIS needs. While not discussed at the forum, Catex also planned to make an equity investment in the transformed MFI and have a Catex manager included in the financiera or bank management team.

These two major projects, MIS installation and transformation to a regulated finance intermediary, were to occur simultaneously. MIS installation had to be completed prior to final negotiations on the transformation to assure the supervisory authorities that Nicarao had sufficient MIS capacity to handle anticipated growth and regulatory reporting requirements. While the timing of the transformation process would be subject to the needs of the local regulatory authorities, Catex planned to complete the MIS installation and staff training programs within a six month time period. Hans would remain with Nicarao throughout the transformation process and Erik anticipated a year and a half assignment

to ensure proper systems follow-up, after which he would be replaced by one of their permanent systems specialists.

Operations: A Decentralized Accounting Example

After the coffee break, Nicarao's Finance Manager, Carmen, spoke about several accounting and operating procedures that needed to be streamlined at Nicarao's recently decentralized offices. The first accounting procedure was the calculation of loan interest payments. Carmen invited two volunteers from Nicarao's cashiers to approach the board and work out a case scenario of a delinquent client's interest payments. Nicarao's other staff members also worked on the calculations in their seats. What was intended as a half-hour exercise and conversation required more than double that time and resulted in a heated discussion as the employees argued over the correct calculation methodology based on training they had received from their respective office managers. The two cashiers came up with different calculations and many in the audience reached still more. The exercise dramatized the inconsistency of training across offices and pointed out the risk of human error inherent in Nicarao's current approaches to calculating interest manually.

Meeting Impressions

It appeared to Chuck that Nicarao's staff enjoyed a warm family relationship. Until two years ago, the staff was less than 50 employees and many saw each other socially outside of work. This feeling still largely prevailed, but with 90 employees and a growing network of decentralized offices, it had now become more difficult to unite staff and provide uniform training. The formal announcement of Nicarao's transformation plan had a dual impact on the employees: it eliminated the informal rumor mill about other possible changes, and it prompted many to wonder whether they would survive the new training or lose their jobs in a new more professional environment. Most of them lacked a college degree and computer experience and they believed the new MIS and credit analysis methodologies would be demanding.

The most significant concern of Chuck and Catex's two consultants was the inconsistency in calculating loan interest payments – a critical element of income in MFI's financial statements. The new MIS must eliminate human error and discrepancies by standardizing/automating these calculations. The

elimination of time-consuming monthly reconciliations would also alleviate a serious bottleneck. As Catex's MIS and credit training components were intimately linked, the implementation of both would have to occur simultaneously and immediately.

The Nicaraguan Microfinance Market

As a newcomer to microfinance, Chuck saw Hans as an important source of industry and market information. Hans was a native Latino (surprising given this name) with extensive experience in microfinance through Catex assignments in East Europe and Latin America. Prior to his Nicarao posting, another consultant familiar with Latin American MFIs had warned him that Nicaragua was the second most competitive MFI market in Latin America after Bolivia. Since Nicaragua was Latin America's poorest country after Haiti, it potentially had an insatiable appetite for microcredit since microenterprises accounted for 96% of Nicaraguan businesses. Yet competition was fierce in many cities. During Hans' earlier assignment in Bolivia, he saw that competition successfully fostered low interest rates and efficient MFI operations. But in Nicaragua, the effects of competition were distorted by the ready availability of donor subsidies. Leading Nicaraguan MFIs had high operating costs (often exceeding 60% of the loan portfolio vs. Bolivia's top program ratios of 17-25%) and high interest rates (the average Nicaraguan microfinance charged interest of 85% per year; many programs exceeded 100%). [Exhibit 7](#) compares microfinance institutions in three different countries. Donor subsidies were apparently supporting inefficient MFI programs (large Nicaraguan MFIs received funds costing 1-5% per year but annual inflation was 7-12%) and their cheap funding did nothing to pressure MFIs to improve their efficiency. Targeted micro-entrepreneurs consequently suffered the most, often paying exorbitantly high interest rates for their loans.

While there were still gaps in access to credit, particularly in the rural areas, the Nicaraguan market was highly fragmented with more than 85 microfinance programs and cooperatives. A recent market evaluation of Nicaraguan MFIs concluded that the situation was shaped by two conditions: the large supply of subsidized funds, and the existence of several European Community cooperatives charging interest rates below Nicaragua's annual inflation rate. The report prepared by an independent consultancy firm concluded:

"As opposed to helping build sustainable MFIs with reasonable interest rate loans, the flood of international donor agency grants and subsidies has resulted in prolonging weak MFIs, many of which charge exorbitant

interest rates to micro-entrepreneurs, the supposed beneficiary of these very programs.”

Hans also noted the Nicaraguan market lacked an important protective feature critical to a competitive MFI market, one that existed in Bolivia: the “Centro de Riesgos” – a system-wide database of delinquent/defaulted borrowers shared among regulated finance institutions (a “black list,” so to speak). Competition provided bad borrowers with ample opportunity to refinance their loans with funds from other MFIs which they were incapable of paying. Unfortunately, Nicaragua’s MFIs were so competitive that the industry consortium was unable to create such a protective system largely due to distrust over sharing bad borrower lists. Instead, a few MFIs periodically exchanged information informally about bad borrowers at regional offices. Obviously this was helpful, but it left the MFI system as a whole open to abuse and increased default risk which would only worsen as MFIs and the supply of microcredit grew.

Nicarao

Nicarao ranked third among microfinance institutions in Nicaragua in terms of number of clients served. (Exhibit 8 presents a list of 14 Nicaraguan MFIs.) Its origins date back to its first office in 1991 in Masaya, Nicaragua’s most important artisan city with its abundance of hammock and wood furniture makers, potters, and other arts and crafts producers. Loans provided working capital for these microenterprises, and in the past, Nicarao complemented its loan product with training classes in business management and accounting.

Nicarao branched out from its Masaya core to 9 other locations. In the last year, it had opened two northern offices in Matagalpa and Esteli, providing a push into the northern regions, and management planned to expand into other northern cities to continue its advance from its southeast origins. Relative to the competition, Nicarao’s advantages were its lower interest rates and longer maturities. Nicarao also offered multiple loan products (including limited housing and rural/agricultural loans), and its transformation plans emphasized individual loans as opposed to the traditional solidarity group loans. Finally, Nicarao was strict with delinquent clients and repossessed collateral to repay such loans. While this annoyed some clients, Nicarao realized the risk of allowing a lax repayment culture to permeate through the organization – possible bankruptcy.

Key Projects: Meeting with the General

Manager

Chuck and Hans met with Marta to review Nicarao’s key ongoing projects on Monday following the special Sunday staff gathering. Marta shared with them Nicarao’s financial highlights (Exhibit 9), its distribution of loan amounts (Exhibit 10) and its organization chart (Exhibit 11). Then she gave a brief description of each of the following:

1. The decentralization of three more of Nicarao’s ten branches.
2. The status of the introduction of the new Catex MIS, brought to Nicarao by Catex.
3. Transformation from a non-profit Foundation to a regulated finance institution (commercial bank or financiera). This still required significant clarifications with the local regulatory officials and further negotiation with the potential investors. The ultimate goal was to complete the formal or legal transformation within the next six months.
4. Consolidation of Nicarao’s central office, which was recently transferred from Masaya to Managua.
5. Opening of 2 additional branch offices in the northern departments of Nicaragua.
6. The possibility of extending its pilot loan program for small-scale agricultural production to other offices (requiring additional finance sources and significant analysis given the greater risks).
7. Updating Nicarao’s credit policies to incorporate Catex’s individual loan methodology and new financial analysis requirements, and include them in a new Credit Policy Manual that would accompany the recently finished Operations Manual.
8. Expansion and diversification of funding sources to support its portfolio growth projections.
9. Investigating new funding/grant sources for Nicarao’s project with Catex (MIS development, staff training, and transformation advisory). Approximately 1/3 of the \$725,000 needed had been secured to-date. Sprout remained optimistic that it would be able to raise the remaining funds.
10. Continued efforts to reduce Nicarao’s loan delinquency rate from 8% to below 5% (fraud by two loan officers combined with the negative impact of

Hurricane Mitch on borrowers repayment capacity contributed to a high delinquency rate, which Nicarao had managed to reduce consistently over the last three months. Though not caught early, corrective actions were taken to protect against future fraud and

the local manager was let go for his lax management style).

Marta then added: "...Employee morale is down, as there is significant productivity pressure on the loan officers to double their present originations in line with industry standards and many employees feared being laid off as part of this transformation and upgrading process. Up to a year ago, Nicarao's loan officer client load was nearly half the field norm for Latin American programs (see [Exhibit 7](#)). "Additionally, our Financial Manager and I have spent considerable time looking for new funding sources to support our portfolio growth (which grew 90% the prior year; see [Exhibit 9](#)), and as you know, we are having difficulties locating sufficient development agency funds to help finance the cost of the new MIS. This has taken much of our time away from daily operations for the moment."

After the meeting, Chuck and Hans went to dinner. Over steaks, gallo pinto, and savory Nicaraguan rum and Cokes, they discussed the General Manager's long list of initiatives. They both agreed that the list was long and that it would be better for Nicarao to focus on its transformation and consolidation before exploring new markets (agriculture and housing) and opening new offices. Aside from her strong staff presentation regarding the transformation, Hans noted that Marta had been somewhat passive in the initial transformation analysis – almost waiting for Sprout and Catex to finish their transformation feasibility study and then readying the organization to implement whatever Sprout decided without too much input from herself.

Decentralization and Expansion

Nicarao began its decentralization process one year ago in response to operating bottlenecks that were impeding office efficiencies and restricting loan portfolio growth. Prior to decentralizing the offices and empowering local office managers with lending authority, all Nicarao's loans had to be approved by the central office Credit Manager or General Manager. This created delays in loan approval, especially when Nicarao grew its customer base to 6,000 borrowers. Nicarao's transformation goal also demanded a more detailed rationalization of costs and confirmation of the profitability-sustainability of individual offices. The qualification for decentralizing an office was that it had to

cover its operating and administration costs. Nicarao completed the decentralization of its last office just before Chuck's arrival.

While growth and efficiency pressures necessitated the decentralization of Nicarao's highly concentrated management operation, not all the precautionary measures were in place to guarantee an ideal implementation. Portfolio management, MIS and Operations guides were still lacking and while an internal audit function had been discussed, it had not yet been drafted. In fact, the still relatively new Finance & Administration Manager, Carmen, was capable of addressing the latter two needs (Operations Guide and internal audit) but she had only been with Nicarao for six months. Carmen quickly identified the critical needs for these two projects but lacked the resources to address them. Further, she was tied up with several other responsibilities including locating new funds to alleviate Nicarao's liquidity shortfall relative to the high market demand for Nicarao's loans.

Over the last two months, the Operations Guide book was drafted and a pilot internal audit was performed at two offices in a move to help design a uniform review process that could be employed at all offices. Nonetheless, 7 of the 10 offices had already been decentralized prior to these initiatives. The new Catex MIS would certainly help in monitoring office performance, with faster and more accurate reporting (delinquency reporting was historically prepared weekly vs. the new system's one day lag). Finally, credit approval authority had already been decentralized to the Branch Manager level, and it was interesting to note that Nicarao's Small Business Loans (individual loans targeted at larger customers with a maximum loan size of \$15,000 vs. Nicarao's average loan size of approximately \$500) had increased noticeably recently and so too had Nicarao's delinquency level.

MIS: For years now, Nicarao had operated without a sufficient management information system to monitor its loan portfolio. Two years earlier, Nicarao purchased and installed Microsys software which was allegedly a sound MFI system product. However, the system was inflexible, it created calculation and reconciliation problems, and eventually it was pulled completely. Returning to Nicarao's semi-computerized system (manual reports were entered into a basic FoxPro data base system) meant that delinquency information was again only available weekly and individual loan officer performance was cumbersome to assess in a timely fashion.

Expansion planning: Recently, with the help of an analyst from Sprout, Nicarao submitted and won donor

support for its northern extension strategy – two new offices and funds to serve 5 surrounding rural communities. In total, Nicarao had received up to \$600,000 in funds to lend to clients, with the prospect that these funds would be converted to equity in three years if Nicarao reached its projected targets (meaning zero cost or grant funds). During the proposal process, the analyst noted some weaknesses in Nicarao's organizational process. For one, it was highly centralized, with the General and Credit Manager designing the strategy with little or no input from the nearby Branch managers initially. Further, they presented the analyst with outdated market data with which to justify their strategy (data was simplistic and largely composed of written memos from site visits made two years earlier). The analyst made sure to call the local managers to gather more conditions but this was less than ideal for office expansion. When asked why they had not shared their opinions with the central office, they responded that they were unaware that senior management was planning an expansion to these neighboring areas.

Transformation through Merger

For the last two years, the majority of Sprout's assistance to Nicarao centered around evaluating the MFI's options for becoming a regulated finance institution and securing additional funds for Nicarao's loan portfolio expansion and outreach mission. By transforming into a regulated entity, Nicarao would be able to mobilize savings from clients (a new source of funds for its loan portfolio expansion) and attract more commercial funding, as banks were often hesitant to lend to non-profit organizations because of the lack of a true ownership structure. Under pressure from Sprout, which was largely guided by the feasibility study recommendations prepared by Catex, it was decided that Nicarao's best option was to merge with FinNic and become ServiMicro, Nicaragua's first regulated finance institution dedicated to serving the microfinance world.

The creation of ServiMicro would present a new approach to transforming non-profit MFIs into regulated entities. The merger would bring together three international investors who knew each other fairly well and a Nicaraguan financial institution whose core operation of lending to medium-sized businesses was becoming too competitive and less profitable. Neither Catex nor the international development fund had prior investment experience in Nicaragua, but Catex had an impressive record managing many MFIs in over eight countries in various regions of the world.

The Players:

Pro Forma Ownership

FinNic: Nicaraguan Finance Company 44%

FinNic had been operating as a financiera for three years. While its overall loan portfolio was not as profitable as Nicarao's, its profits were on a continual upward trend. FinNic's deposits are described in [Exhibit 12](#). FinNic had a significant small- to medium-sized customer portfolio and its merger with Nicarao signaled a deliberate shift in strategy – to focus more on micro-entrepreneurs with a reduction in its larger-sized corporate portfolio. Its proposed 44% interest in the new institution included the merger of its Nicarao operation with its earlier investment in a small microfinance operator.

MEF: Microfinance Equity Fund 15%

This international development fund, supported by several multilateral development agencies, had an ultimate goal of placing equity investments in strong, sustainable, and regulated MFIs to ensure access to credit for micro-entrepreneurs in developing countries. Microfinance was viewed as a very important tool for poverty alleviation and an important element of MEF's mission. MEF generally sought a 10% investment level that included a position on the Board of Directors to protect this investment and influence strategy.

Catex: Consulting Business 10%

This Dutch consulting firm historically made its debut in microfinance with the introduction of its MIS product. Since then, it had grown tremendously with projects on several continents. Most recently, Catex had been considering equity investments in some of its high potential consulting clients. With this new institution in Nicaragua, Catex planned a 10% equity ownership. While extremely capable, criticisms of Catex included: inflexibility in applying their MIS product and lending methodology to local conditions, their extreme control position (wanting to head the new institution, for example), and their costly fees which were among the highest in the industry.

Sprout: Nicarao's Parent Organization 31%

Sprout operated microfinance programs principally in Africa and Latin America. Its thrust was economic empowerment assistance in developing countries as a tool for fighting poverty. It founded Nicarao in 1991 and Nicarao was their strongest microfinance affiliate and by

far their largest investment to-date. One of its key objectives was the creation of sustainable development programs that yielded a return to Sprout (in either interest payments on debt or dividends paid for equity) that could then be invested in Sprout's other international programs still requiring nurturing.

ProDev was a potential fifth investor to the expanded institution. It had investments in over ten countries and many of its managers had been major investment bankers with significant international experience. They now wished to lend their expertise to promote private sector development in poor countries.

Each participating institution had a strong sustainability and profitability focus. Nonetheless, the social missions of Sprout and ProDev were the mainstays of their existence. Both parties took comfort in the fact that if ProDev joined the group they would represent the largest equity investment in the new institution to be called ServiMicro.

Given the complex nature of receiving the Bank Superintendent's approval to create the first Nicaraguan microbank, it would also be important for Nicaragua to locate a well-connected political figure as a Board Member. Recently they located an ex-Banking Superintendent official who had left her position to pursue consultancy work. She had worked in several government ministries and also conducted prior microfinance research for a competitor that attempted to become a commercial bank but gave up on the process (many speculated their operating costs were too high). It appeared she might provide excellent insight and guidance for Nicaragua's transformation. Though the actual management structure for the proposed microbank was still under negotiation, most likely the General Manager position would be assumed by FinNic's top manager and Marta would assume the Credit Manager position, given her extensive experience with Nicaragua's microfinance portfolio.

Combining the Businesses

Costs

The total cost of Nicaragua's transformation was estimated at over \$725,000 and could approximate \$1,000,000 by completion. The \$725,000 estimate had three main components: (1) MIS equipment and software installation; (2) training in financial analysis, credit methodologies and accounting for office staff; and (3) transformation advisory work for the investors with the Bank Superintendent. At the time, Nicaragua had an approximate \$2,500,000 loan

portfolio so these institutional investments appeared very high. Funding was being sought primarily from multilateral development banks and international donor agencies, in combination with grants and low interest loans. To date, roughly \$250,000 had been secured.

Vehicle Choices

Nicarao and the new institution's owners had to decide whether they should transform into a commercial bank or a *financiera*. Both alternatives had the same equity requirement (see [Exhibit 2](#)), yet the commercial bank could offer broader savings products and demand deposit (or checking) accounts. Given the proposed union with FinNic, already a regulated finance institution with a Bank Superintendent charter, it might be easier to simply merge into the existing finance company. Further, the minimum \$2,000,000 capital requirement for banks was under debate within Congress with a strong likelihood that it would be increased to \$5,000,000 or even \$10,000,000 the next year. If greater than \$5,000,000, then ServiMicro could not consider the commercial bank option as this was too much capital to raise. It could require significant resources to institute a short-term savings/checking product. FinNic already had significant medium-term deposits (see [Exhibit 12](#)) but since finance companies were prohibited from collecting short-term deposits (<90 days), it lacked experience in designing and delivering this product. The short-term deposits were important to micro-entrepreneurs who often needed quick access to their limited savings for not only business purposes but unanticipated family needs.

Management and Personnel Issues

Management

While realizing the huge significance of Nicaragua's transformation, the General Manager was often frustrated with the process and felt like she was losing control. Many key strategic transformation decisions were being made at senior levels – between Sprout's North American management, Catex's European management, and the supporting development bank. In particular, two items that bothered her personally were: (1) the transformation would place greater emphasis on profits and this would preclude Nicaragua's entering more rural markets where there was noticeably less supply of credit and greater poverty, and (2) the new MIS was inflexible in accommodating Nicaragua's customer prepayment options. Consequently, rural outreach would diminish given the higher costs of serving these remote communities and the lower micro-entrepreneur density would limit the new institution's outreach potential. New prepayment

restrictions would not allow clients to make partial prepayments and would even limit their options for when they make these prepayments – reducing their potential interest cost savings (at 60% annual interest rates, these savings could be large). This would lower client incomes and possibly cause an increase in delinquencies, as clients decided to use excess cash in other less productive ways and potentially risk future loan payments. Marta felt powerless given the fact that the parent organization was managing the contract with Catex, and she questioned her ability to protect the clients from such unfavorable changes. She was also uncertain about her role in the future institution.

Choosing the new General Manager: It was apparent from communications with Sprout's local Country Director that future senior management negotiations were becoming contentious. FinNic's investors, as the largest single shareholder group in the new institution (but still less than 51% control), thought their General Manager should assume the top position. Catex thought that one of their Dutch senior directors should assume management control, given their driving role in the transformation and extensive experience managing other successful MFI transformations. Also, they wanted to protect their 10% ownership, they did not view Nicrao or FinNic General Managers as strong candidates, and they had the implicit support of MEF given their prior project affiliations with MEF. Nonetheless, it seemed strange to consider a foreign manager for Nicaragua's soon-to-be first regulated finance institution targeted at the smallest, most informal micro-entrepreneurs. Some thought that would give the impression they were a foreign supported institution, perhaps even dependent on international aid monies, thus potentially lessening their image as a profitable, private institution with long term staying power.

It was evident that the General Managers of Nicrao and FinNic were critical and often distrustful of each other. Nicrao felt that FinNic's microenterprise portfolio was weak with high delinquencies and that its managers might try and use ServiMicro to raise support among micro-entrepreneurs for the Sandinista party. Nicrao also felt that FinNic was a bit out of touch with micro-entrepreneurs financial needs and repayment capacity – with FinNic's General Manager eager to offer credit cards almost immediately to micro-entrepreneurs. To FinNic, Nicrao's managers lacked the sophistication, exposure to government dealings and long term vision that they possessed as a regulated finance institution.

Finally, all of FinNic's senior management and Catex's consultants were men – a stark contrast to Nicrao where two of its top three positions were held by women (the

General Manager and CFO). Microenterprise clients of Nicrao and most MFIs were approximately 70% female, an industry standard given that women constitute the largest portion of the world's poor and have less access to traditional finance than men.

Loan Officer Training

All of Nicrao's loan officers had a high school degree and most had completed or were in the process of completing some type of university business degree. Credit training was managed by the Credit Manager and Office Managers. Initial class instruction by the Credit Manager was followed by hands-on work at the regional offices under the guidance of the local Office Managers. The training was sufficient under Nicrao's previous solidarity group lending model, but it would not suffice under the new plan to offer individual loans and raise productivity targets. (Nicrao's portfolio had shifted from 70% solidarity group to 70% individual loans over the last year.) Individual loan methodology required much more sophisticated financial analysis, and the majority of Nicrao's staff lacked those skills. After some initial class instruction, Catex quickly realized that over half the loan officers would require significant, expensive training to get their skills up to speed and to break their "old habits" and ways of analyzing credit. In fact, Hans did a quick analysis, which showed that it would be cheaper to hire new college graduates in finance and teach them about microfinance than to teach these detailed financial concepts and analysis to Nicrao's staff over the next 6 months. Obviously, this would be a sensitive issue and one that Catex was not confident Sprout or the development bank would be willing to support – the potential lay-offs of longstanding Nicrao staff. Finally, it was important to keep in mind that Nicrao's loan officers came from the same low-income neighborhoods as many of its customers and understood their clients' mindsets, needs, and business challenges.

Conclusion

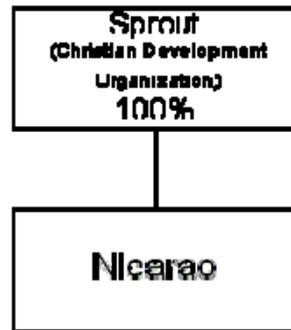
ProDev Investment Decisions

Chuck's week visit came to a quick close. He was impressed with Nicrao's growth prospects under the new institutional framework, and comfortable with the management controls being instituted from an operations standpoint – a strong MIS, uniform operating standards and guides, and plans for internal audit. Despite his appreciation for the numerous changes underway, he was a bit uncertain regarding the amount, type and timing of his investment. His conservative side told him to wait 6-

12 months for the transformation to be complete before making an investment to ensure its positive direction, while his gut told him to get involved right away with the original group of investors and play an active role in the new institution's formation. He also preferred that his investment be used to finance some income generating assets (i.e. new client loans) as opposed to paying the costs of transformation (Nicarao was still searching for international development funds to support the Catex consultancy work). Financial and portfolio projections for the new entity appear in [Exhibit 13](#) and [Exhibit 14](#). Key highlights of Nicarao's proposed merger-transformation over the next three years were as follows:

1. The potential to grow a microfinance portfolio from roughly \$3 million to \$11 million and its client base from Nicarao's 6,000 clients to 22,000.
 2. Growth in profits from \$144,000 to over a \$1 million dollars.
 3. Plans to lower operating costs significantly from
 - 40%+ of the loan portfolio to 25%.
 4. Building assets with higher yields: net earnings/loan portfolio = 4.1%, significantly higher than traditional commercial bank yields anywhere. While not completely decided, the preliminary plans were to reinvest earnings in growth – thus an equity investment would not produce cash dividends for at least three years. Yet, a debt investment would not provide ProDev with the management control and technical assistance contribution it sought for its investments. Chuck reviewed again ProDev's Investment Objectives ([Exhibit 15](#)) and decided to communicate his positive interest to Nicarao and the other investors but without committing himself to investing in ServiMicro immediately. He needed to get back to the States and review things with a clear head and greater objectivity.
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Exhibit 1
Ownership Structure of Nicarao MFI
Present Ownership Structure of
Nicarao



Proposed Ownership Structure of
New Merged MFI

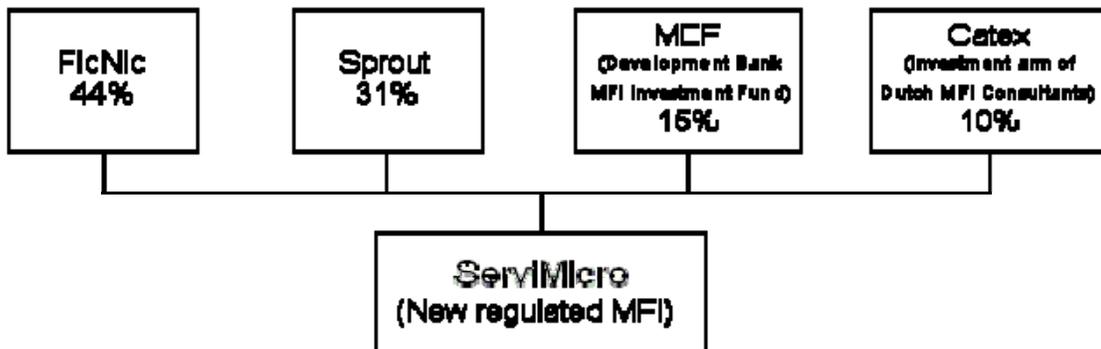


Exhibit 2

Nicaraguan Regulated Financial Institutions

	Commercial Bank	Finance Company
Minimum Capital	\$2,000,000	\$2,000,000
Deposit Taking Capabilities	All deposits demand and savings deposits	Only deposits > 90 days no demand deposits
Minimum Stockholders	10	10
Minimum # of Directors	5	5
Other	External commerce products (letters of credit, etc.)	No external commerce products

Source: Bank Superintendent

A new banking law might increase minimal capital requirements for *commercial banks* from \$2,000,000 to \$5,000,000, some have pushed to raise it to \$10,000,000.

Exhibit 3

Distribution of Nicrao's Portfolio

Office	% of Portfolio
Masaya	29
Granada	15
Managua (3 offices)	14
Rivas	12
Esteli	9
Jinotepe	8
Tipitapa	7
Matagalpa	<u>6</u>
	100%

Exhibit 4
Map of Nicaragua



Exhibit 5

Background Updates on Nicaragua

Macroeconomics: Nicaragua's economic development was largely constrained by the country's significant debt burden (roughly 3 times its annual GDP); issues of property rights, cronyism, and transparency/corruption issues, and insufficient infrastructure (transportation etc, linked to limited government funding). Nicaragua's unemployment rate was among the highest in Latin America and its \$500 annual per capita GDP reflected the severity of its poverty problem and necessity for microfinance to support the high number of self-employment businesses. Finally, inflation had been running between 7-12% annually, and the government adjusted for this by automatically devaluing its currency 1% per month. To manage its own asset-liability matching risks (much of Nicaragua's financing was dollar-based vs. client loans in Cordobas), Nicaragua's added a 1% monthly interest premium on client loans to match this devaluation. This was standard procedure for Nicaraguan banks' Cordoba-based loans.

Government: The conservative Liberal party won the 1996 elections and since then Nicaragua's President attracted significant international capital, improved many of Nicaragua's infrastructure shortfalls, privatized many of Nicaragua's state enterprises, and brought inflation under control (despite the annual 12% devaluation adjustment, actual inflation for 1997 averaged 7%). Despite these advances, the average Nicaraguan's economic plight did not improve, with low wages and high unemployment persisting. Most Nicaraguans believed that the current President was corrupt largely because he had accumulated several large real-estate properties during his presidency and Nicaragua's economy continued to struggle despite considerable foreign aid. Strong political polarization between the Sandinistas and the more conservative Liberal and Conservative parties continued. Government policies towards local NGOs working on a broad range of socioeconomic development projects were often non-supportive, allegedly because the Sandanista party had historical links to several of these non-profit organizations.

Sources: US State department data, Nicaraguan financial periodicals and public opinion from newspapers

Exhibit 6

Nicaraguan Economic Indicators

	2001	2002	2003
Real GDP Growth Rate	3.0%	1.0%	2.3%
Inflation Rate (annual)	4.8%	3.9%	6.0%
Exchange Rate (cords/\$)	13.4%	14.3%	15.1%

Source: Nicaraguan Central Bank

Exhibit 7

Comparative Microfinance Indicators

	Nicaragua Nicarao	Bolivia BancoSol	El Salvador El Calpia
Return on Portfolio	62.0%	32.0%	39.0%
Delinquencies	5.4%	1.1%	2.7%
# Loans/Loan Officer	228	416	342
Operating Costs/ Average Portfolio	46.7%	17.6%	17.3%
Financial Costs/ Average Portfolio	16.0%	9.7%	11.0%

Exhibit 8

Nicaraguan Microfinance Institutions

	Portfolio (\$thousands)	Number of Clients
NITLAPAN	\$ 4,200	4,280
CEPAD / PRESTANIC	3,125	5,502
ACODEP	3,100	9,630
FAMA	3,100	11,071
NICARAO	2,250	6,610
CARUNA	2,140	5,035
FINDE	2,030	1,457
CEPRODEL	1,560	2,080
FACS / FIDESA	1,107	1,328
ASODERI	1,080	1,780
F. Jose Nieborowski	992	1,974
CESADE	440	970
CARMA	251	300
FONDEFER	199	1,309
	<u>\$25,574</u>	<u>53,326</u>

Exhibit 9

Nicarao Financial Highlights

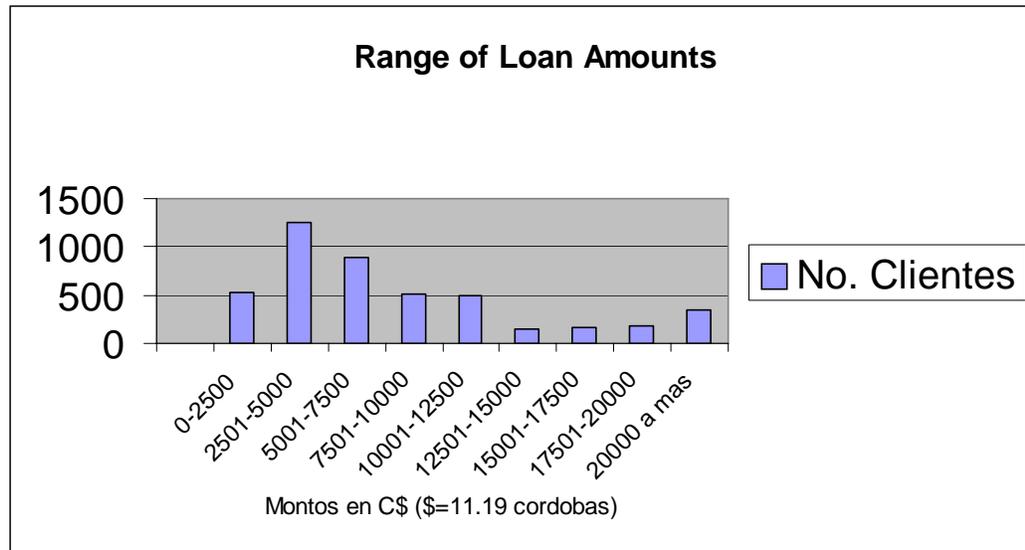
(Thousands of Cordobas)

	2001	2002	2003
Portfolio	7,543	10,712	20,330
Assets	9,301	12,845	23,167
Liabilities	7,946	1,524	16,475
Equity	1,355	11,322	6,692
Liabilities/ Assets	85%	12%	71%
Clients	4,646	4,968	6,610
% Women	65%	67%	70%
Annual Loan Fundings	29,220	36,366	72,198
Average Loan Size	2.6	3.3	4.1
Net Financial Income	3,630	6,557	9,719
Net Income	735	1,959	1,544
Admin Costs/Avg Portfolio*	37.8%	50.0%	46.7%
Net Income/Equity	74.5%	30.9%	17.1%
Sustainability	122%	139%	113%
(Income/All Costs: operating + financial)			

* Costs exclude depreciation; average portfolio uses gross portfolio as base

Exhibit 10

Nicarao Loan Amount Breakout



Note: Roughly half of the portfolio loans are <\$500, with these smaller loan sizes demonstrating Nicarao's commitment to serving the smallest of microentrepreneurs (with low income levels): 40% of credits are less than C\$5,000 (\$447) and 82% are less than C\$15,000 (\$1,117). Credits over C\$ 20,000.00 (\$1,787) are 8%.

Source: Finance Dept Nicarao

Exhibit 11 Nicarao Foundation Organization Structure

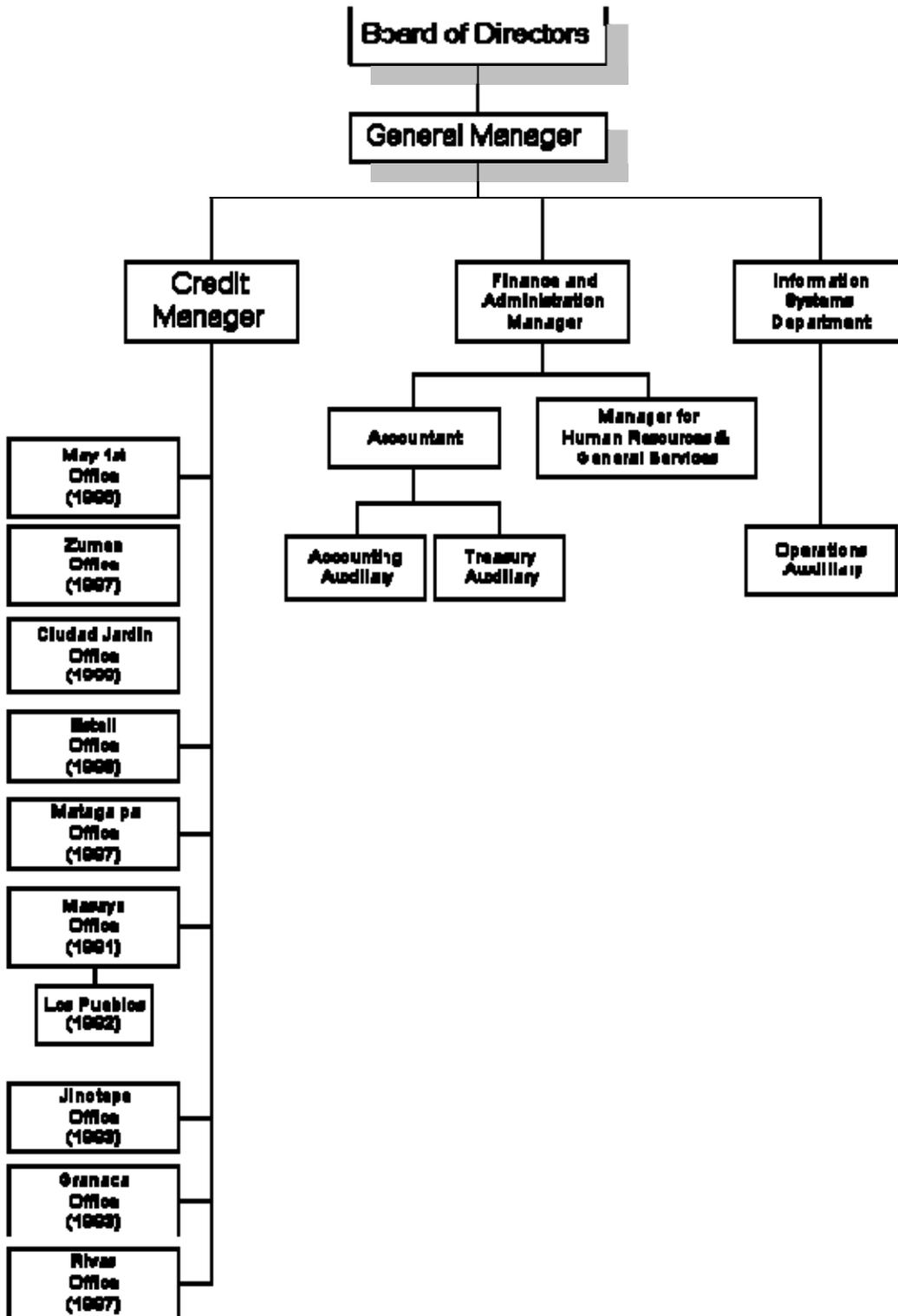


Exhibit 12

Deposit Information for FinNic

\$ thousands	Amount (\$)	Percent	% in \$	% in Cordobas
Savings Deposits	3,294	19%	5%	95%
Fixed Term Deposits	14,383	81%	41%	59%
Total	17,677	100%		

Source: Catex

Exhibit 13

ServiMicro Financial Projections

\$ thousands	Nicarao	ServiMicro Pro Forma Consolidated	Year 1	Year 2	Year 3
Micro-Loan Portfolio	2,250	3,245	3,085	5,811	11,085
Loan Portfolio	2,250	14,586	16,704	19,617	24,912
Total Assets	2,588	24,668			
Deposit Liabilities	-	19,648			
Debt	1,799	2,263			
Equity*	704	6,061	5,656	5,409	5,852
Net Income	130		244	359	1,023
Portfolio:					
# clients (micro-small)	6,881		10,308	14,378	22,434
Loans/Loan Officer/Month	18		36	40	50
Admin and Operating Expense/Average Portfolio	46.7%		45.0%	35.0%	25.0%
Portfolio at Risk	8.6%		5.0%	4.5%	3.8%
Personnel	90	125	146	188	233
Source: Consultants					
Notes: * Pro forma consolidated equity of \$2,377 reaches \$6,061 via a \$3,684 equity injection from new owners.					
Also, the diminishing equity in year 1-2 reflects the affect of an assumed devaluation of 12% / year.					
As inflation has been running 7% a year, this devaluation impact on reduced equity should be offset.					

Exhibit 14

ServiMicro Loan Portfolio Projection

Type of Loan	Year 1	Year 2	Year 3
Microcredit	18%	30%	44%
Corporate	56	46	34
Personal	<u>26</u>	<u>24</u>	<u>21</u>
Total	100%	100%	100%
# borrowers (micro-small)	10,308	14,378	22,434

Source: Consultants

Exhibit 15

ProDev's Investment Objectives

1. Profitable Return
2. Promotion of Social Development Initiatives in Developing Countries (poverty alleviation, health and nutrition, environment)
3. Minimal 10% Ownership Stake for Equity Investments
4. Board of Director Position
5. Sustainability: the project must be profitable, demonstrating at least two years of full cost coverage and projected earnings improvement.
6. Outreach: Projects must demonstrate capacity to expand their outreach noticeably

Miscellaneous Considerations:

- The organization's management must have a true commitment to social objectives
- ProDev prefers equity investments, but it can consider debt placements.
- Return requirements are flexible, so long as they are positive and principal is well protected.
- Sovereign risks must be well managed
- Term: 5-year investment strategy norm, while longer term investments will be considered so long as there is an annual investment return/dividends.
- ProDev's management focuses on the preservation of investors' capital and the realization of socio-economic objectives in developing countries. ProDev's investors tend to be wealthy and socially progressive individuals who do not depend on the fund's returns for their future livelihood. - ProDev targets annual returns of 5-10%, as generated from a mix of interest, dividends, or equity participation sales.

ENDNOTES

¹ This case was written by Louise Schneider of Johns Hopkins University under the supervision of Professor Richard Linowes of the Kogod School of Business at American University in Washington, D.C. It was produced in conjunction with the Emerging Markets Development Advisors Program (EMDAP) under the sponsorship of the US Agency for International Development (USAID) and managed by the Institute of International Education (IIE). Some information in the case has been disguised. The case is meant to serve as the basis for class discussion.