

NICARAO: Transforming a Non-Profit Microfinance Organizationⁱ

NICARAGUA

Case Description

Nicarao is a top microfinance player in Nicaragua undergoing major “growth pains.” Last year’s 90% portfolio growth could not be adequately tracked by the present management information system so that needs to be replaced with a new reputable MIS. Furthermore its centralized institutional structure was recently decentralized to improve operating efficiencies. Decentralization is largely complete, the MIS is in implementation, and Nicarao is in the process of a major transformation to becoming Nicaragua’s first regulated microfinance institution. It is the most exciting year in its history and it is occurring in one of Latin America’s most competitive microfinance markets.

Teaching Purpose & Objectives

The case calls upon students to evaluate whether an investment in the new institution, ServiMicro, makes sense given ProDev’s investment criteria. It attempts to make students grapple with numerous management issues and institutional changes that are occurring simultaneously, providing a good foundation for discussing priorities and the correct sequencing of institutional initiatives.

The basic questions posed to students are as follows: (1) Is Nicarao’s transformation strategy the appropriate way to reach scale? and (2) Would they make an investment in the new entity if they were Chuck Barrett, the financial analyst?

The principal issues to be discussed in the case are business strategy and investment decision-making. The potential investment of ProDev in a high profile international development project must be weighed

against numerous factors including: multiple changes being simultaneously introduced as part of a planned merger/ transformation project, management concerns, some political and macroeconomic instability, growth risks, and institutional and funding shortfalls.

Students are also forced to consider other criteria for investments beyond financial return. With ProDev, they must consider outreach and poverty alleviation, the likelihood of constructing a long-term viable institution for the poor, and the ability to protect at minimum investor’s principal. Additionally, they are faced with considering the geographic instability of Nicaragua, a country laden with volcanoes, a history of devastating earthquakes, and annual threat of serious hurricanes.

Position in Course

Suggested Courses: Economic Development, Strategy, Finance, Operations Management, Organizational Behavior

Themes: Institutional Change, Strategic Planning, International Investments, Microfinance, Economic Development, Cultural Issues

Economic Development:

- Microenterprise as a tool for growing small informal businesses and increasing employment
- This transformation brings together five different kinds of organizations involved in economic development: a regulated finance institution, a multilateral development bank, a non-profit microfinance organization, a consulting company, and a private international investment fund.

Strategy:

- The transformation of a non-profit microfinance organization into a regulated finance institution
- Nicarao’s decision to drop its client Training Program
- Nicarao’s intent to transform while continuing several other initiatives (new office openings, new products such as agricultural and housing loans)

Operations Management:

- Decentralization of operations and decisionmaking authority
- Merging three entities' operations (Nicarao, FinNic and its owner's MFI investment)

Finance:

- Tapping new sources of funds for growth (commercial banks, investment funds)
- The subsidized nature of Nicaragua's MFI market as a risk to future profit-oriented financial institutions like ServiMicro targeting microentrepreneurs long term.

Organizational Behavior:

- Nicarao's female General Manager was excluded from some key meetings on the strategic transformation.
- Nicarao staff's fear of being laid off.
- Management of the new institution led by a foreigner

Break-out and Assignment Questions:

The majority of case time should be spent on evaluating the investment decision, followed by a review of strategy and operations issues discussed below.

Economic Development & Investments: Should Chuck Invest?

(1) Investing in a major transformation project when roughly 2/3 of the required financing is missing (Nicarao has raised \$250,000 of the \$725,000 needed). If Chuck decides to invest in the institutional upgrade, when would be the appropriate timing, and should it be a debt or equity investment?

(2) The subsidy risk. International donors may continue subsidizing inefficient non-profit MFIs, the new institution's primary competitors. As a private, for-profit institution, the new entity would most likely be cut off from these international donor funds with its more commercial perspective and fundraising capabilities. These subsidies could reach a level where such competitors drop their interest rates and the new entity can no longer compete and cover costs, unless it succeeds at lowering its operating costs as dramatically as forecasted (from approximately 45% to 25% of the loan portfolio).

(3) What are the risks to investing in Nicaragua, and can they be mitigated?

Political polarization, 7-12% annual inflation, some socioeconomic instability (transportation and student strikes), and Mother Nature risks (hurricanes, volcanoes, earthquakes).

(4) Ownership: Should Nicarao and Sprout be given increased equity ownership in ServiMicro for the \$600,000 in donor agency funds that may convert to equity in three years, if they reach their program targets? Nicarao and Sprout secured these funds independent of the other owners.

(5) Does it make good sense to expend \$725,000 on training, MIS implementation, and advisory work related to the transformation of an institution with a US\$2.3 million portfolio and prospects of growing to a US\$11 million microfinance portfolio in three years?

Highlight how the underlying funds will have to be low cost loans or grants from development organizations.

Strategy: What is the best transformation route?

(1) What is the ideal transformation vehicle – bank or finance company?

Given the uncertainty of the \$5 or \$10 million minimum capital requirement to become a bank, Nicarao and the investor group would be wise to choose the finance company route for two reasons: (a) Nicarao's merger partner, FinNic, already has its charter, speeding up the approval process and ability to merge the two operations, and (b) this route is less costly. The banking option would have required a lot more work for both Nicarao and FinNic to present their application and adjust their operations. The reporting requirements would probably also be more exhaustive, given the ability to accept demand deposits and the Bank Superintendent's need to protect depositors with more frequent monitoring.

(2) Is Nicarao attempting too many initiatives this year? How should they be prioritized?

In fact they are. It would be better to focus on the most important two projects, MIS implementation and transformation. Nicarao should maintain its existing product offerings and limit new office openings until these institutional changes are better established. The potential sacrifice is growth and possibly even an erosion of its market base, given the extremely competitive environment.

(3) Are the large upfront costs of the transformation (\$725,000) justified? – These were based on the growth projections.

If one accepts the growth projections and prospects of creating a permanent and regulated microfinance institution, then yes, the investment is warranted. Students should suggest verifying Catex's assessment and forecasting track record on its other microfinance assignments.

(4) Is the Nicarao, Sprout, and ProDev social outreach mission served by transforming into a regulated, for-profit, financial institution? Yes, but sacrifices are made en route.

What are the prospects that the institution will be able to preserve its focus on providing credit to the poor to improve their economic situation? In theory, the transformation should result in faster and larger growth

and outreach, but maybe Nicarao will not be able to “dig as deep” in reaching the poorest of the poor given the higher costs of reaching these more rural areas and analyzing these marginal credits.

Management and Human Resources (Organizational Behavior):

(1) Reporting structure. Nicarao’s General Manager felt excluded from key strategic decision making. She consequently was unable to influence MIS changes related to customer prepayment flexibility and justify some rural operations of Nicarao, which means that some sites are now being targeted for closure.

(2) Gender: Does there seem to be a “macho” factor at play here, since Nicarao’s female manager was excluded from many of the all male strategic meetings? Maybe the large number of players involved in the creation of the new entity necessitated negotiations just among a limited number of institutional representatives. What could Sprout do to make Nicarao’s Manager feel more involved? Some possibilities: calling her once every other week to fill her in on key initiatives and solicit her feedback. Right now, he is screening all information via the local Sprout Country Director who, while competent, is not strong in finance. Finally, there is a communication issue – Sprout’s chief does not speak Spanish, while its country director is fluent in both Spanish and English. Finally, Nicarao’s Manager speaks mediocre English. Is her exclusion simply a reflection of language barriers or more?

It is true that Marta sometimes could be difficult to deal with, but her microfinance knowledge and commitment to customers is real. She also has a good head for finances and strong educational background. She has the best understanding of the microentrepreneur customer among all the parties involved in the transformation and should be representing their interest at some of these meetings. Her occasional complacency during this planning and transformation process suggests that she may not have the ideal leadership skills to lead the new institution, but her experiences and training would allow her to contribute materially to strategy, credit and marketing.

(3) Work hours: How to motivate staff to practically double their work hours for weeks at a time while they are not paid overtime and have not received a pay raise in 3 years?

- They were overpaid in the past relative to the market, resulting in the pay freeze.

- Unemployment is high and the risk of staff turnover is low.

(4) Job insecurity: how should Nicarao and the consultants put the staff at ease, reassuring them that they would be allowed some time to get their skills up-to-speed under the new training?

Nicarao’s management should have placed more emphasis at the beginning that the loan officers would be given time and opportunity to improve their skills. Catex also came on a bit strong at the beginning of training. Consequently, everybody was so scared from the get-go that hardly anybody asked questions during the initial month of training and this was reflected in the number of loan officers who failed the first exam. Finally, Catex’s credit training was much more sophisticated than the educational backgrounds of most loan officers.

(5) Staff replacements: Based on an expected reduction in transformation costs and the probability that college-educated finance analysts would be more productive, should Catex push the other owners to layoff and replace some low performing Nicarao loan officers? Or should it give Nicarao’s loan officers an opportunity via training classes to develop the necessary financial skills?

Remember, the bottom line is that, despite low loan officer productivity ratios in comparison with other top performing regional MFIs, Nicarao is believed to be the only fully self-sustainable MFI in Nicaragua. It has been profitable, covering all its costs, while acknowledging that it does receive low interest donor loans and institutional strengthening grants for MIS and other investments. Yet unemployment is high in Nicaragua and several accountants and skilled workers drive taxis, meaning that depending on the salaries offered, it should be possible to find interested candidates. Finally, one must consider the impact of laying off dedicated loan officers in an institution with a clear social mission where dedicated staff has been working since Nicarao’s inception.

(6) Management: Who should head ServiMicro?

A Nicaraguan? – Nicarao’s General Manager who has the most experience with Nicaraguan microentrepreneurs, OR FinNic’s General Manager who is more familiar with the Superintendent’s regulation procedures since they have been a regulated finance company for 3 years, OR the foreign consultant from Catex who has broad experience in microfinance in Latin America and Eastern Europe transforming microfinance organizations into regulated entities.

Operations and Decentralization: Was the sequencing and pace of decentralization correct?

Nicarao’s decentralization was an important necessity for accommodating its growth and preparing for eventual transformation. Nonetheless, the orchestration of this decentralization presents serious issues regarding the correct sequence of effort.

What should have been the sequencing of Nicarao’s decentralization?

They decentralized first, then wrote their Operations Manual, then brought in the new MIS. Was this acceptable given the transformation/merger opportunity? Did decentralization occur too quickly (approximately one year)? Should the internal audit have been conducted

prior to each office's decentralization? The quick decentralization helped reduce bottlenecks in new customer processing and speed response to storm disasters, but contributed to the rise in loan delinquencies from 5% to 10% of the portfolio and the loan frauds at its Managuan offices.

(2) MIS: The inability to quickly assess the reason for rising delinquencies is related in part to Nicaragua's lack of a good MIS system. More specifically: how long did it take the Credit Manager's office to catch the fraud in Managua? Reports did not track performance by office but rather by type of loan, meaning that senior management was not able to quickly catch the problems at a singular office: Better/more frequent MIS reports could have limited the downside; delinquent reports now come out only weekly, meaning that it often takes loan officers a full week to know when their clients are late. More recently the MIS team has been modifying these portfolio reports to see the results by office.

(3) MIS: basic discussion of the pros and cons of designing a custom system vs. purchasing a pre-written (pre-tested!) system, there are sacrifices to be made in terms of adjusting the loan structures to accommodate the new MIS (risks of client departures because of less flexibility and higher effective charges, etc...)

Political and Regulatory Issues:

(1) The proposed banking law has created uncertainty regarding the new minimum capital requirement – \$5 or \$10 million. This has a large implication for Nicaragua and the new institution, which cannot reach this \$10 million requirement if this is imposed. How should they mitigate this risk?

(2) There is no Centro de Riesgo (shared system that provides the names of borrowers that have defaulted on loans to other financial institutions) in the Nicaraguan Banking system for unregulated MFIs. How can Nicaragua and the new institution minimize this risk with its peers going forward?

Maybe the microfinance consortium should create a database to share this information monthly among microfinance institutions, to protect their portfolios from bad borrowers.

(3) The possibility of an underlying Sandinista agenda, given that the Sandinista owners of FinNic hold 44% of the new entity equity. What is the real risk here? – that the new owners market the new institution as a bank for the underprivileged? That, thanks to the Sandinistas, there is access to credit for microentrepreneurs via a stronger, regulated finance institution?– would this accumulate votes for the Sandinista party or perhaps politicize the institution and make non-Sandinista borrowers look elsewhere for their services? One might suppose that the majority of the poor are Sandinista supporters anyway, given their social platform. Actually

FinNic's owners are successful Nicaraguan businessmen who relate to the Sandinista party. Perhaps in modern day Nicaragua the political issue is no different than the squabbling between American Democrat and Republican parties in the U.S. – both want economic growth but they differ on the role they assign to public programs. It is unclear whether all private property would be protected if they returned to power.

Update and Recent Developments

(1) Management chose the Finance Company route. It was too risky to get involved in the bureaucratic delays that would result with changing bank regulations, and the timing was unfavorable given recent commercial bank frauds and possible bankruptcies (one might see microfinance as much riskier, as these informal loans are generally unsecured by acceptable bank collateral, despite the fact that their repayment rates are much better than commercial banks. Additionally, it is important to remember that the capital requirements to become a commercial bank were higher and likely to increase further).

(2) One year after the arrival of Catex, the transformation to a finance company was almost complete. The operations were still in the process of merging. Some of Nicaragua's managers were working at FinNic's other microfinance operation, cleaning up things as it was a weak program.

(3) Management Decisions: FinNic's top manager headed the institution for the first year or so. Nicaragua's General Manager was to become the Credit Manager for the microfinance operations and its CFO and Credit Manager absorbed into their relative departments. However, Marta, Nicaragua's General Manager, resigned, even though she was amenable to accepting the Credit Manager position for microfinance at ServiMicro. Whether the position was rescinded is unknown.

One of Catex's top Dutch managers headed the new institution after the first year, with FinNic's managers assuming most of the secondary positions and Nicaragua behind them.

(4) MIS: The system is up and running relatively smoothly and the staff are happy to be rid of manual calculations.

(5) Customers: Nicaragua's customers were annoyed with the prepayment inflexibility and penalties, but there did not seem to be any major fall-outs to-date.

(6) The specific player in the ProDev investment scenario is fictional but significant capital and equity funds have recently flowed into this and other microfinance organizations. Students should attempt to evaluate whether a mutual fund should make such investments and how ServiMicro would pay dividends. ServiMicro was to be a private company and dividends were feasible based on their profitability.

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).