emeraldinsight

Managerial Finance

Leveraging donor funds: the switch to commercial funding

Nicholas Biekpe, Josephat M. Kiweu,

Article information:

To cite this document:
Nicholas Biekpe, Josephat M. Kiweu, (2009) "Leveraging donor funds: the switch to commercial funding", Managerial Finance, Vol. 35 Issue: 12, pp.1011-1026, https://doi.org/10.1108/03074350911000061
Permanent link to this document:
https://doi.org/10.1108/03074350911000061

Leveraging donor funds: the switch to commercial funding

Nicholas Biekpe
Graduate School of Business, University of Cape Town, Rondebosch, South Africa, and
Josephat M. Kiweu
University of Stellenbosch Business School, Western Cape, South Africa

Abstract

Purpose – The purpose of this paper is to highlight important factors that influence funding decisions from the perspective of commercial lenders, and suggest commercialization of microfinance as a source of alternative development finance.

Design/methodology/approach – A survey of industry experts on funding decisions representative of proponents of commercial microfinance is conducted to help provide views on the most important considerations in their lending practice.

Findings – The study finds that specific critical success factors define minimum pre-conditions for microfinance institutions considering commercial funding as an alternative source of finance. The study reveals that the three most important considerations for lending evaluation are transparency in financial reporting, sound financial management, and previous history of borrowing.

Research limitations/implications – The study carried out is based on a relatively small sample and puts significant reliance on respondents' opinions.

Originality/value – This is probably one of few attempts to explore the possibility of a linkage between microfinance and capital markets. The paper will be of interest to microfinance institutions, commercial banks, international donors and wholesale funds with an interest in investing in the microfinance industry.

Keywords Critical success factors, Financial institutions, Capital markets, Financing, Gearing

Paper type Technical paper

Introduction

It has long been stated that funding is a major constraint in microfinance. It slows the growth and expansionist activities of microfinance innovation in many developing economies. This is despite the recognition of the fact that microfinance has contributed immensely to the creation of sustainable livelihood in poor societies, and micro-enterprise development. This paper examines how to help microfinance institutions (MFIs) successfully secure additional growth capital for their credit programs.

The growth rate of microfinance initiative has been high in many countries, but funding levels in the industry have not matched this growth. This is particularly of concern when we consider the decreased availability of donor traditional sources of finance, and the uncertain capacity of MFIs to access alternative funds (Carlos and Carlos, 2001; KIPPRA, 2001). We propose a financing strategy for MFIs and develop effective strategies for fruitful interaction with alternative fund markets.

Commercial sources of funds can play a greater role in relaxing the financing constraints facing MFIs. This source of finance although driven by different considerations than those for donor funding has not been used widely to fund microfinance. However, commercial finance is arguably a viable alternative for providing massive long-term resources for growth. This research suggests that successful commercialization of microfinance will provide innovative sources of development finance for MFIs.

A first draft of this paper was presented at the WIDER international Conference on "Sharing Global Prosperity" at Helsinki, Finland from 6-7 of September 2003.

Managerial Finance
Vol. 35 No. 12, 2009
pp. 1011-1026

0307-4358
DOI 10.1108/03074350911000061

The purpose of this paper is to establish the importance commercial-lenders'/investors' attach to various factors relevant for financing reformation of the microfinance industry. It examines the factors that influence the decision to finance microfinance operations. We develop an understanding of critical success factors (CSFs) from the perspective of commercial lenders that provide MFIs with valuable guiding principles for attracting the financial markets. Appropriate use of CSFs will enhance an MFI's competitive ability over the rivalry for scarce funds.

The growing scarcity of donor funds and increasing MFI competition for funding has sparked increased interest from the financial markets. However, many MFI managers do not understand the most important factors that drive successful attraction of commercial funding. Therefore, an investigation of CSFs for implementation of an alternative source of finance for microfinance was worthwhile to carry out.

Identifying factors[1] that enhance successful attraction of leveraged funds could potentially reduce the funding constraints of MFIs. We develop an exit strategy; away from "captive" donor funding and underscore the role of commercial intermediation and argue that adoption of success strategies in accessing financial markets can "shape the future" of microfinance financing strategy.

An overview of funding environment and relevant literature

Role of commercial finance in microfinance intermediation

Before we discuss *commercial finance* in more detail, we need first to clarify our use of the term. By *commercial finance* we refer to funds raised from interest bearing debt contracts. Such funds require (obligate) the MFI to pay interest, that is, are interest-paying liabilities. *Commercialization* on the other hand is defined as the funding of an MFI's expansion operations and lending portfolio with commercial finance.

This paper underscores the importance of commercialization and shows the relevance of its contribution to the furtherance of the microfinance initiative. The process of commercialization gained momentum in 1996/1997 – after industry players realized that donors did not have enough funds to push through the course for microfinance (CGAP, 1997). Both donors and practitioners are in agreement of the role commercial actors can play in funding microfinance.

Microcredit for enterprise development attracts much of its funding from donors and subsidized state run credit schemes. This method of financing microfinance poses a threat to sustainability of programs. However, the approach to solving financing constraint in microfinance has always been inward looking. This underscores the need for an exit strategy; away from "captive" donor funding that has characterized the industry.

While donations represent an important source of funding for microfinance, their scope is limited. It has been established that as a company consolidates its products and delivery processes in the marketplace, it becomes a candidate for external funding (Jeng and Wells, 2000). Consequently, as MFIs grow and expand their need for external funding increases continuously.

The incoming of commercial lenders will not only provide capital but also: increased transparency, promotion of commercial loans in microfinance, enhanced credibility and a positive signal to other fund providers as well as MFI-reputation[2] intermediation (Black and Gilson, 1998). Hence a major role for commercial finance is to establish and build a refinancing capability for profitable operations of microfinance. This will lead to commercial finance becoming a key financing consideration; and could be the final switch for MFI-funding relationship with the larger formal financial system.

Challenges to commercialization

By and large, commercial funding is not optimal, but can be optimized to play a key role in financing fast growing MFIs. Rapidly growing firms often want to use external financing (Upneja and Dalbor, 2001; Berger and Udell, 1998). However, a solid foundation is required for this financing strategy.

Commercial lenders find it difficult to create an interest for the costly market of microfinance. The costs are due to information asymmetry for selection of viable institutions: informal nature of the organizations, poor business infrastructure, low efficiency reputation and NGO culture, the cost of loan administration (screening and monitoring), and such efforts. A great deal of research has focused on these constraints and other impediments (Hattel and Halpern, 2002).

When firms commercialize an innovative business model (new interface), they face two major challenges (Ziamou, 2002): first to identify how the new innovation can function optimally and secondly to effectively communicate with relevant markets to reduce uncertainty about the new innovation's performance. Microfinance has dealt with the first issue quite successfully. However, the second challenge is a great detriment to its progress in commercially driven microfinance.

The "communication problem" remains the main bottleneck to the "ease of doing business" between the financial markets and MFIs. Although effort has been made to understand microfinance context through evaluations and appraisals, ratings and lessons learnt type studies, very little has been done to reflect the perspective of the financial markets. We suggest this as the "missing connection" to the vast money markets. MFIs need to understand what alternative fund markets require and therefore attain necessary capacity to engage them. Then, the capital flow can begin!

Key issues in critical success approach

The critical success approach is an accepted method for corporate strategic planning (Chen, 1999). This method based on the technique of factor analysis aims to identify factor structures present in a set of variables (Child, 1970). Factor analysis identifies small number of factors (with minimum loss of information) that represent relationships among a set of interrelated variables (Sureshchandar *et al.*, 2002).

Rochart first defined the concept of CSFs in 1979 (Chen, 1999), as the "limited number of areas in which results, if they are satisfactory, will ensure competitive performance for the organization". Boynton and Zmud in 1984 also defined CSF as the "few things that must go well to ensure success for the manager or an organization" (Chen, 1999). These authors emphasize the fact that CSFs highlight key performance requirements for achieving success in a defined strategic direction. The method enables the researcher to describe a group of "reliable measures" from a large set of variables where attention must be focused and where things must go right.

Chen (1999) derived four CSFs in the banking industry: ability of bank operation management, ability of bank marketing, ability of developing bank trademarks and ability of financial market management. By undertaking factor analysis of the CSFs for educational institutions seeking to market themselves internationally, Mazzorol (1998) identified four underlying dimensions as well. In a consideration of credit criterion used for evaluating mortgage loans, Liu and Lee (1997) identified eight critical factors. They named them as, market price of collateral, loan to value ratio, borrower education level, marital status, sex, terms of the mortgage and so on[3].

In an attempt to find out the CSF for total quality management in Hong Kong industries, Antony *et al.* (2002) identified seven CSFs (from 72 questionnaire items) that gave high factor loadings (i.e. factor ladings >0.55) to indicate their importance. The seven CSFs consisted of 38 items.

CSF identification helps management take steps to improve potential for success. They provide management with a measure (rating tool) on which improvement efforts can be focused. In the context of microfinance practice, we use CSF approach to measure the relative importance of key considerations for commercial lending by a group of "experts".

The relevance of the CSF approach is seen in its ability to aid preliminary screening of MFIs suitable to pursue commercial microfinance. MFIs will also be enabled to assess their internal capacity and sense of preparedness. Management is therefore better informed on the likelihood of success, as well as areas where it must direct its efforts to win the markets.

Data and methodology

Data were collected through a questionnaire sent to: lenders/fund providers, microfinance technical advisors, development agencies, consultants, social investors, rating agencies and bankers. The method of gathering data was the Internet. This method was chosen due to the advantage of sending the survey document to a large number of respondents simultaneously and cheaply.

Research method used perceptions' and experiences of people involved in commercial microfinance in the industry worldwide (Thiagarajan and Zairi, 1998). The target group was drawn from informed international players committed to promoting commercialization, and/or those responsible for lending decisions. The questionnaire was designed to measure individual's perception of the relative importance of a set of possible factor considerations.

Survey design and success factor determination

The literature provided an applicable list of potential success factors in the context of microfinance and money lending industry. A critical aspect in the evolution of a fundamental theory in any management concept is the development of good measures that enable the researcher to obtain valid and reliable estimates of the domain of interest (Sureshchandar *et al.*, 2002). The development process[3] begins by first substantiating adequate representation of the constructs; with the aim of identifying relevant interventions (valid factors) that are vital for success in commercial lending. Based on a comprehensive study of economic literature, finance and banking theory, the factor items were assembled.

An initial questionnaire was presented to academics and other microfinance reviewers for refinement (Kelsey and Bond, 2001; Sureshchandar *et al.*, 2002). This exploratory approach was intended to unearth and ensure a complete list of commercial lending practice criterion. A final list of 53 potential success factors of MFI access to commercial funding was collectively identified.

Survey framework and approach

The Microfinance Experts Panel (MEP) 2002 survey document consisted of three parts: Part I contained 53 potential success factors, while Part II consisted of question number 54 meant to test completeness of the dimensions of commercial microfinance. In recognition of the disparity of evaluation criteria, Part III (question 55) sought to find out the respondents' experience of the five most important considerations in lending practice.

The "experts" were asked to indicate the importance of each of the 53 potential success items on a Likert scale of 1-4, ranging from "Not important" to "Very

Important", respectively. The Likert measurement examined the respondent's perception and experience on each item's importance rating.

The survey used a personal contact approach[4] in collecting the views of informant respondents[5] (Madill *et al.*, 2002; Sureshchandar *et al.*, 2002). The respondents constituted industry "experts" representative of proponents of commercial microfinance as much as was possible. A total of 117 emails were sent to MEP experts in 17 countries[6] that formed the operational base of the respondents. An attached official letter introduced and explained the purpose of the study (Chen, 1999). The respondents were asked to contact the researcher for any clarification, and indicate their consent for participation.

From these 117 contacts, a total sample of 44 respondents committed to participate in the survey after periodic follow-ups. Securing agreement to participate was not easy. The MEP 2002 survey document was sent to 44 experts in the sample, with clear instructions. A final usable sample of 36 replies was returned representing 30.7 percent response rate.

Key findings and interpretation

Table I shows the number of countries in each region, and corresponding respondents who participated in the study. The findings indicate majority (61 percent) of the respondents were linked to microfinance programs in Africa.

The analysis of the questionnaire responses showed that the highest number of respondents (about 40 percent) was lenders and social investors. The percentages of the respondents' areas of expertise are shown in Figure 1.

The importance rating is listed in Table II. First, the mean scores of the Likert ratings were computed. Then, individual mean values were used as an indicator of the item's importance, without regard to other items (Chen, 1999; Rungasamy *et al.*, 2002; Mazzorol, 1998). A factor item with the highest mean score is considered as the most important factor.

	Region				
No. of countries/respondents	Africa	Americas	Asia	Europe	Total
Number of countries	8	3	3	3	17
Number of respondents	22	7	4	3	36
% of respondents	61	20	11	8	100

Table I. Distribution of respondents among operational regions

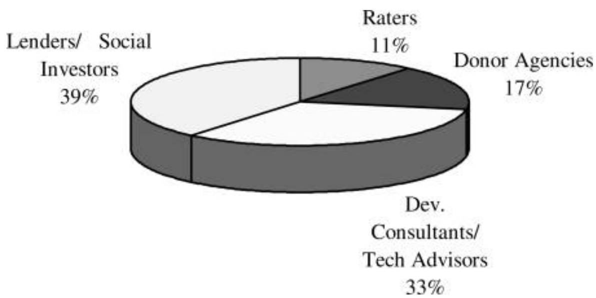

Figure 1. Respondents' areas of expertise

Count	Qn	Success item	Mean rating
1	3	Availability of relevant information	3.75
2	4	Portfolio quality	3.72
3	8	Proper record keeping and adequacy of financial reporting system	3.69
4	20	Sound financial management practices	3.61
5	23	Availability of audited accounts	3.56
6	12	Availability of appropriate and experienced management team	3.53
7	1	MFIs potential and growth prospects	3.50
8	6	Extent of business risk in the institution	3.50
9	18	Financial sustainability level (profitability track record)	3.50
10	27	Extent to which MFIs is a formal organization	3.43
11	40	Adequacy of cash flows to service commercial loans	3.36
12	22	Reputable board and good/effective governance	3.31
13	45	Total cost of borrowed funds, i.e. repayment burden and other costs	3.19
14	9	Reputation risk of institution in previous borrowing	3.17
15	5	Returns achievable from investing in microfinance opportunities	3.14
16	31	Adequacy of MFI's system of borrower selection criteria	3.08
17	38	Lender's strategy and financing policy	3.08
18	13	A formal business plan for marketing MFIs business strategy	3.06
19	53	Supportive legal mechanisms for settlement of claims	3.00
20	43	Exposure to commercial sources of funds and networking advantage	2.89
21	52	Availability of appropriate financial instruments	2.92
22	47	Availability of wholesale (funds) or other financing arrangements	2.92
23	26	An appropriate debt-equity ratio	2.90
24	28	Cost of making loans to MFIs, i.e. screening, administration costs	2.86
25	48	Stable macro-economic environment	2.86
26	51	Financial sector liberalization, including supportive banking reforms	2.86
27	29	Ability to meet customer demand with appropriate products	2.81
28	24	An orientation towards private sector approach to micro lending	2.83
29	25	Purpose of funds	2.75
30	36	Degree of MFIs operational autonomy from external influences	2.78
31	35	Strong capital base (equity for leveraging risky funds)	2.78
32	19	Legal personality status	2.72
33	50	Availability of investment funds targeting MFIs	2.67
34	2	Size of MFIs	2.67
35	10	Supervision and regulatory status	2.58
36	14	Total number of clients	2.56
37	30	MFIs stage of development	2.58
38	41	Years of existence, i.e. long track record.	2.58
39	11	MFIs lending methodology	2.50
40	49	Extent of development of financial markets.	2.56
41	15	Credit rating score	2.47
42	32	Ownership; including mix and composition of stakeholders	2.50
43	44	Inadequate supply of subsidized finance to the MFIs	2.47
44	46	Lack of sufficient retained earnings	2.39
45	21	Extent of MFIs openness and acceptance of intrusion by investors	2.42
46	34	Lender's exposure and appreciation of microfinance operations	2.33
47	7	Possession of adequate (type) collateral	2.36
48	37	Type of institution, e.g. bank, NGO, limited company, credit union	2.33
49	17	Extent of product and delivery innovations, technologies pursued	2.31
50	16	Extent to which ethical image, social responsibility drives decision	2.19
51	33	Location of MFIs business	2.22
52	42	Unused debt capacity	2.17
53	39	MFI's commitment to poverty lending strategy	2.03

Table II.
Results of mean importance rating

While we have a good indication of what commercial lenders demand to make decisions, until now, we still were not sure how they prioritized among important considerations. But Table II shows us key considerations in a lending decision. First, availability of relevant information, followed by specific requirements for portfolio quality, proper record keeping and adequacy of financial reporting system, sound financial management practices, and availability of audited accounts as the top five success factors with a mean ranging from 3.56 to 3.75. Table II also shows a number of success factors were rated below 3.00 – i.e. below the "important score".

Data analysis

A factor analysis was undertaken on the 53 success factors to identify the critical factors. The general purpose of factor analysis was to summarize the information requirements for commercial lending. The analysis proceeded in an exploratory mode[7] (Zhang *et al.*, 2000; Sureshchandar *et al.*, 2002).

Factor analysis was done using Statistica computer package and principal component extraction method (Antony *et al.*, 2002; Mazzorol, 1998). As per this analysis, only factors having eigenvalues greater than 1 are considered significant (Harman, 1976; Child, 1970; Chen, 1999). A varimax rotation was applied for ease of data interpretation and determination of common factor structures (Hopkinson and Pujari, 1999). Factor loadings were used to provide cut off for success factor items at + or −0.55.

Absolute factor loadings greater than 0.3 are considered significant; loadings of 0.4 important; if loadings are 0.5/0.6 or greater, they are considered very good and very significant (Antony *et al.*, 2002; Zhang *et al.*, 2000; Hopkinson and Pujari, 1999). High factor loadings suggest[8] that the factors are critical (Antony *et al.*, 2002; Chen, 1999; Nunes, 2002). We derived ten factors accounting for 85 percent of variance in the data, thus omitting 11 success items that did not score above + or −0.55[9].Table III shows ten factors all with more than one eigenvalues, as per Kaiser's criterion[10].

Interpretation of factor analysis results

The ten factors address and relate to issues of concern on which this research is based. Success items must relate to each other for an appropriate factor model. Where the correlation is too small (as shown by factor loadings <0.55), it is unlikely that the items have some property in common. Hence such items are not grouped together, and have been omitted in Table III (see Table IV).

Value	Eigenvalue	% total variance	Cumulative variance	Cumulative, %
1	10.60602	20.01136	10.60602	20.01136
2	5.83763	11.01440	16.44365	31.02576
3	5.54441	10.46116	21.98806	41.48691
4	4.66696	8.80558	26.65502	50.29249
5	4.06849	7.67640	30.72352	57.96890
6	3.74136	7.05917	34.46488	65.02807
7	3.51890	6.63943	37.98378	71.66750
8	2.77668	5.23902	40.76046	76.90652
9	2.39944	4.52725	43.15990	81.43377
10	1.94670	3.67301	45.10660	85.10679

Table III. Number of factors and eigenvalues

Variable (Var.), success items	Mean score	Significant factor loadings only, F = factor structure F1	F2	F3	F4	F5	F6	F7	F8	F9	F10	Total/ Var. /F
Question 27	3.43	0.89										1
Question 40	3.36	0.78										1
Question 4	3.72	0.68										1
Question 23	3.56	0.60										1
Question 3	3.75	0.59										1
Question 5	3.14		0.90									1
Question 15	2.47		0.70									1
Question 45	3.19		0.68									1
Question 17	2.31			0.83								1
Question 14	2.56			0.79								1
Question 50	2.67			0.78								1
Question 34*	2.33			0.64	0.56							2
Question 33	2.22			0.57								1
Question 16	2.19			0.57								1
Question 32	2.50				0.83							1
Question 30	2.58				0.74							1
Question 36*	2.78				0.72		0.60					2
Question 9	3.17				0.66							1
Question 38	3.08				0.58							1
Question 18	3.50				0.58							1
Question 49	2.56					0.91						1
Question 51	2.86					0.77						1
Question 48	2.86					0.69						1
Question 52	2.92					0.66						1
Question 2	2.67					(0.58)						1
Question 20	3.61						0.86					1
Question 22	3.31						0.73					1
Question 19	2.72						0.66					1
Question 8	3.69						0.64					1
Question 43	2.89						0.64					1
Question 29	2.81						0.62					1
Question 12	3.53						0.62					1
Question 7	2.36							(0.92)				1
Question 28	2.86							0.70				1
Question 44	2.47								0.78			1
Question 13	3.06								0.76			1
Question 46	2.39								0.66			1
Question 39	2.03								0.57			1
Question 25	2.75									0.84		1
Question 10	2.58									0.68		1
Question 21	2.42										0.84	1
Question 41	2.58										0.73	1
Expl. variance		20%	11%	10%	9%	8%	7%	7%	5%	5%	4%	85%
No. of success items		5	3	6	7	5	8	2	4	2	2	*42

Note: *Total scaled down by two items which loaded onto two factors, i.e. Question 34 and 36

Table IV.
Results of rotated factor matrix

It should be noted that the success items with the largest values provide the flavor of the factor. These factor items indicate the factor structure and are used for labeling or naming the factors in this study (Child, 1970; Chen, 1999; Hopkinson and Pujari, 1999; Jain, 2001; Nunes, 2002). The full name list of critical success strategies (CSFs) obtained from factor analysis is shown in Table V. Full list of success items within CSF are shown in the Appendix.

CSF approach helped us understand the importance attached to the set of evaluation criteria used by industry players. From the set of 53 potential success factors we identify and highlight the ten CSFs for accessing commercial funding.

Factor 1 collects five success items that deal with issues related to ability of MFI formalized operational structures to produce reliable and transparent financial information. Commercial lender's decision to fund microfinance is met with uncertainty and lack of relevant information. Factor 1 captures the relevance and soundness of information obtainable from the MFI for informed decision making. Key to this is the question of accountability of the reporting structures of the MFI. We labeled factor one as "*Extent of formalization and transparency in financial reporting*".

Factor 2 was loaded onto by three items that refer to assessment of business risk and creditworthy of an MFI. Capitalists would like to know how viable an MFI is as an investment destination of their funds. Factor 2 was named "*Viability of investment in microfinance*". *Factor 3* includes six items that focus on microfinance outreach innovations. This factor captures the "core service" of microfinance innovation and practice. It was named "*Microfinance practice and extent of product-delivery innovations*".

Factor 4 consists of seven items relating to MFI operational maturity, credibility and ownership structure. Accordingly, this factor was labeled "*Operational reputation and stage of development*". *Factor 5* was loaded by five considerations that are essential for support and a thriving business of microfinance. These items represent external environment factors conducive for the practice of microfinance: liberalized financial sector, stable macro-economic environment, supportive banking reforms and financial instruments tailored to microfinance to enable financiers make contractual agreement with MFIs. Factor 5 was named "*Extent of financial market reform and enabling environment*".

Factor 6 contains the highest number of items that loaded onto it. This critical factor consists of statements, which relate to management of microfinance business and its effective leadership. For this reason, we labeled this factor as "*Sound financial management and good governance*". *Factor 7* loaded only two items. The two micro-loan items refer explicitly to key strength of microfinance lending. They reflect the fact

	Critical success factors by name	Importance score	Priority level
1.	Extent of formalization and transparency in financial reporting	3.56	1
2.	Viability of investment in microfinance	2.93	4
3.	Microfinance practice and extent of product-delivery innovations	2.38	10
4.	Operational reputation and stage of development	2.94	3
5.	Extent of financial market reform and enabling environment	2.77	5
6.	Sound financial management and good governance	3.22	2
7.	Secure loan default risk	2.61	7
8.	Sparse and limited donor funds	2.49	9
9.	Transformation for funding access	2.66	6
10.	Commitment to privatization and shareholding exposure	2.50	8

Table V.
Description of critical success factors

that micro-lending is not constrained by lack of collateral. And though the loans are expensive, this does not deter lending as "other" loan default guarantee mechanisms work better in microfinance. The higher factor loading on adequate collateral (the key item) is negative indicating these loans are meant to be unsecured. Therefore, factor seven is titled "*Secure Loan default risk*".

Factor 8 contains four items relating to sources of funding and fund raising methods. We label this factor "*Sparse and limited donor funds*" and regard it as indicating the fact that MFIs need to be capital starved to seek alternative funds (Jain, 2001). An MFI must have a financing need (necessity[11] for cash) beyond current donor fund flows; this provides the required drive to seek capital from alternative sources. Availability of easy (cheap) money however impairs with MFIs initiatives for accessing commercial funding.

Factor 9 collects only two items: supervision and regulatory status, and purpose for funds. This latent factor can be labeled "*Transformation for funding access*". It summarizes the notion and industry perception that a regulated status makes an MFI better suited to tap fund markets. Hence, MFI's main reason[12] for transformation into "conventional" legal forms. In many countries an institution cannot be allowed to take deposits (a cheap source of funding for MFI), unless it's regulated.

Finally, *Factor 10* contains two success items relating to managerial ownership retention. This factor refers to the idea that only mature organizations may have the willingness to invite outsiders to share in ownership and development of their institution's growth. We find that MFIs that accept to open-up their institutions to "outsider capitalists" are likely to be more successful in accessing growth funds, all other being equal. We name this factor "*Commitment to privatization and shareholding exposure*".

Conclusions, summary and implications

Although a formal legal structure is said to offer potential for financing, one thing is clear, MFIs lack guidelines and known strategies for growth in commercialization. This research fills this gap, and enhances a commercialization option, as well as allaying fears of potential capitalists.

Our research has derived ten CSFs for raising funds from commercial fund markets. They reflect ten financing goals for MFIs. It is indicative from all the CSFs identified that MFIs must attain certain performance conditions designed to woo prospective sources of development finance. The findings of this grounded research offer a solid foundation for a winning strategy. The result of this study allows us to confirm the importance of transitional factors influencing the success or failure of the switch to commercial sources of funding.

Analysis and interpretation of the responses to the MEP questionnaire allowed objective judgment in reaching a consensus on perceived importance rating of success factors. The emphasis was to understand, "what are the key drivers?" of commercial lending decisions. The analysis enabled identification of critical and absolutely essential evaluation criteria that an MFI should meet to successfully access commercial funds. These considerations explain MFI success – path clearly and the implications for managerial direction.

The selection of an investment partnership in microfinance at the moment is a one-way matching problem. The investor/lender incurs considerable risk and resources to carefully evaluate a suitable organization. On their part, MFIs play a minimum role in the decision process. However, the course of action to take and the manner of preparation is, to say the least, far from clear. There is no consistent agreement across the industry regarding the most important success factors, not to mention the critical ones. However, CSFs will make it possible for individual MFIs to study their situation and make note of their assessed scores with regard to CSF requirements.

The listed ten factors are not equally important, based on mean score ranking on Table V. The first factor "*Extent of formalization & transparency in financial reporting"* contains success items that are highly rated in importance by participants. Factor 1 comprises more than half of the first five key success items, and two of the three most important considerations in Table II. We single out the other key determinant of credit evaluation decision as factor 6, i.e. "*Sound financial management and good governance*". This factor contains three success items in top six as per Table II.

Using our measurement scale in the survey, the above two CSF factors alone pass the test of importance (a score of 3 and above) as can be seen in Table V. In fact, the MEP 2002 survey responses revealed: management capacity, portfolio quality, governance issues and adequacy of financial information are considered most important factors by lenders. These results confirm widespread information opacity in the industry. Thus, ability to refine the reporting system and avail information to support informed decisions is a key achievement for success.

In our test of consistency between perceptions held by surveyed respondents and what they practiced, we found there is a direct correlation between factors perceived to be important and actual criterion used by lenders. Most respondents (on question 55) consider: first, the quality of the portfolio, second, quality of management and effective governance and thirdly, transparency in account records and reliability of financial reporting systems. The CSF list therefore compares well with the considerations cited as evaluation criteria in the industry.

Implications of results to microfinance practice

The need to satisfy funding requirements by practitioners is increasingly pressing by the day given urgent microfinance objectives of poverty alleviation and development of micro- and small enterprise sector. As noted by Consultative Group to Assist the Poor (CGAP, 2002), a "sustainable MFI is not limited to donor funding, but can draw on other alternative sources to cater for the growing needs of its target market". A commercial approach leading to market-oriented financing is therefore necessary for continued provision of quality financial services to the poor (Christen and Drake, 2001).

The CSFs perspective seeks alternative measures that an MFI should take towards alleviating constrained donor funds. Use of success factors in developing a financing strategy could allay the difficulties faced by MFIs in attracting funding. Such an effort will make them acceptable by the financial markets. Focus in microfinance should now be given to areas that are important for achieving access to alternative funds.

CSF provides the value of a finance-planning tool for long-term financing and growth. They determine (set) priorities among success factors and provide valuable guidelines for MFI financing integration with the larger financial system. Adoption of CSF as a planning instrument will make an MFI more focused and effective in fund raising from the broad money market. We propose commercial capital financing to be the "missing link" in enhancing and backing the success of MFIs with innovative technologies and tremendous growth potential.

CSFs equip lenders and potential capitalists with a powerful decision-making tool. CSF existence conveys a positive outlook of an MFI's long-term viability. CSF approach is an important mechanism for assessing the risk of funding microfinance prospects. Transparency afforded by CSFs will help to change the reputation of microfinance to financiers. The possibility of a linkage (between microfinance and capitalists) will mean gained access, and industry freedom from donor syndrome and precedence. This "communication" breakthrough finally will provide a necessary platform for the switch to commercial finance.

Inferences, limitations and future research agenda

The primary focus of this paper is to showcase the factors commercial lenders/investors believe are crucial for effective loan contracts with MFIs. The findings suggest three most important considerations for lending evaluation as the concern for transparency in financial reporting, sound financial management and good governance, and previous borrowing reputation. For MFIs adopting commercial microfinance, necessary pre-screening strategies can guarantee good performance on meeting requirements and satisfying commercial lenders' concerns.

Introducing a Preparedness Performance Index (PPI[13]) of attractiveness, with respect to each CSF would be an appropriate benchmarking tool. A modified survey instrument can be used to measure the level of preparedness (attractiveness) for MFIs in need of external financing. The self-assessment tool would seek to establish the "extent to which organizations fulfill/comply with identified success requirements for funding access". The rating would give a preparedness score for each success item on a particular CSF strategy which can be used as a basis to prioritize areas for improvement action. An institution performing to the full extent of CSFs would be a good candidate for commercial funding.

The limitations of this study should be acknowledged. We took the views of "thought leaders" as the source of our information. Although this approach has merit given the aim of the study, other personnel caliber may have had different suggestions. Most of the participants were drawn from programs in Africa. Perceptions drawn from a balanced sample may have generated significantly different experiences. Interpretation of the findings could be limited to the context of dominant respondents. A larger sample was obviously desirable.

Data set from MFIs may offer different opinions on what drives success in a commercial lending. Alternatively, the extent of consensus in opinion on the criticality of the CSF could also be established from microfinance organizations. Further research is needed to fully explore the nature of these CSFs. Finally, this paper is a product of on-going research addressing alternative-financing models for MFIs. The current paper is limited to identification of key factors of success, and any generalization of our CSFs beyond the microfinance context should be made with caution.

Summary remarks

The microfinance industry has experienced tremendous growth. This has been fueled by poor societies' eager to develop sustainable micro-enterprises as a strategy for poverty alleviation. However, current enthusiasm is often tempered by a limitation of development finance. First, because of constrained donor funds, and secondly, because MFIs find it difficult to obtain funding from the larger financial community that views such investment as unattractive and high risk.

Microfinance financing models relying and focusing on donor financing have limitations and are not able to reach more poor societies that are in dire need of financial services. The alternative-financing model presented in this paper explores what it takes to finance microfinance while leveraging on scarce donor funds. This model encourages investment in and development of microfinance, and identifies criteria used by commercial lenders and other capitalists when considering funding an

MFI. This model, therefore, offers an alternative to institutions at the cutting edge of enterprise development and market reforms.

We argue that possessing qualifying attributes determines the ability of an MFI to attract commercial funding. This is motivated by the fact that as organizations (including MFIs) grow and develop, they begin to reach the limit of their traditional funding sources (Berger and Udell, 1998; Upneja and Dalbor, 2001).

Given the growing shortage of donor funds (main traditional source of capital for MFIs) the failure to develop effective success strategies that promote alternative funding sources will limit the potential impact of microfinance on economic development. The ten CSFs highlighted in this paper provide a realistic checklist for self-assessment of MFI's progress in a commercialization strategy. This pre-screening tool will enable management to realign critical success strategies and tactics to correct identified deficiencies and control for disappointments arising from premature moves for commercial funds drive.

Notes

1. These factors provide the necessary drive sufficient to move MFIs to financial independence – self-sustaining pattern of financing.
2. It is to be remembered that this industry, given its NGO background is not exposed to the financial markets.
3. Rungasamy *et al.* (2002) analysed 12 CSFs on statistical process control on UK small and medium enterprises. They gave the order of importance as follows: management commitments, process prioritization, control charting, teamwork and so on. Linehan and scullion (2001) highlighted a number of critical factors, which are necessary for successful female expatriate assignment, using the CSF approach.
4. That is, respondents were personally contacted and the survey explained to them in detail. An attached letter solicited and exalted the recipients to participate in the study.
5. Held in New York, 2001.
6. See CGAP website.
7. Exploratory factor analysis aims at unearthing underlying factors that illustrate relationships among a set of interrelated items. Factor loadings are used to present these relationships.
8. Other factor loadings are considered insignificant and can safely be dropped in the selection process.
9. Meaning that only 42 out of the 53 success items were suitable for factoring.
10. Only factors having eigenvalues greater than 1 are considered significant for extraction.
11. If other sources avail sufficient capital there would be no need for additional funds! Hence, the main sources of funding for the MFI should be stretched to the limit.
12. Microfinance has in recent times operated with dual objectives: the traditional social objective and the emerging commercial objective.
13. The PPI would be computed as the average value (of the mean scores) of the various success items that load onto the CSF. The PPI values of all the CSFs will provide an overall picture of the level of preparedness of the institution. Management can keep these indices as yardsticks on which improvement effort can be focused.

References

Antony, J., Leung, K., Knowles, G. and Gosh, S. (2002), "Critical success factors of TQM implementation in Hong Kong industries", *International Journal of Quality & Reliability Management* Vol. 19 No. 5, pp. 551-66.

Berger, A.N. and Udell, G.F. (1998), "The economics of small business finance: the roles of private equity and debt markets in the financial growth cycle", *Journal of Banking & Finance*, Vol. 22, pp. 32-55.

Black, B.S. and Gilson, R.J. (1998), "Venture capital and the structure of capital markets: banks versus stock markets", *Journal of Financial Economics*, Vol. 47, pp. 243-77.

Boynton, A.C. and Zmud, W. (1984), "An assessment of critical success factors", *MIT Sloan Management Review*, Vol. 25 No. 4, pp.17-27.

Carlos, D.C. and Carlos, C. (2001), "Commercialization or transformation of NGOs to regulated institutions: African experience", paper presented at the Conference on Challenges for Commercialization, Washington, DC.

CGAP (2002), "Helping to Improve Donor Effectiveness in Microfinance, Microfinance Donor projects: 12 Questions about Sound Practice", Donor Briefs No. 1, Consultative Group to Assist the Poorest, Washington, DC.

Chen, T. (1999), "Critical success factors for various strategies in the banking industry", *International Journal of Bank Marketing*, Vol. 17 No. 2, pp. 83-92.

Child, D. (1970), *The Essentials of Factor Analysis*, Holt, Rinehart & Winton, London.

Christen, R. and Drake, D. (2001), "Commercialization of microfinance", working paper, *Microenterprise Best practices (MBP)*, Development Alternatives, USAID Project, Bethesda, MD.

Harman, H.H. (1976), *Modern Factor Analysis*, 3rd ed., Revised, The University of Chicago Press, Chicago, IL.

Hattel, K. and Halpern, S.S. (2002), *Challenges to Microfinance Commercialization: Conference Summary*, Microfinance Network & ACCION International, The World Bank, Washington, DC.

Hopkinson, G.C. and Pujari, D. (1999), "A factor analytic study of the sources of meaning in hedonic consumption", *European Journal of Marketing*, Vol. 33 Nos 3/4, pp. 273-94.

Jain, B.A. (2001), "Predictors of performance of venture capitalist-backed organizations", *Journal of Business Research*, Vol. 52 No. 3, pp. 223-33.

Jeng, L.A. and Wells, P.C. (2000), "The determinants of venture capital funding: evidence across countries", *Journal of Corporate Finance*, Vol. 6 No. 3, pp. 241-89.

Kelsey, K.D. and Bond, J.A. (2001), "A model of measuring customer satisfaction within an academic center of excellence", *Managing Service Quality*, Vol. 11 No. 5, pp. 359-68.

KIPPRA (2001), *Legal and Other Constraints on Access to Financial Services in Kenya. Survey Results*, Special Report, Kenya Institute for Public Policy Research and Analysis, Nairobi.

Linehan, M. and Scullion, H. (2001), "Repatriation of European female corporate executives: an empirical study", *The International Journal of Human Resource Management*, Vol. 13 No. 2, pp. 254-67.

Liu, D. and Lee, S. (1997), "An analysis of risk classifications for residential mortgage loans", *Journal of Property Finance*, Vol. 8 No. 3, pp. 207-25.

Madill, J.J. *et al.* (2002), "Determinants of SME owners' satisfaction with their banking relationships: a Canadian study", *International Journal of Bank Marketing*, Vol. 20 No. 2, pp. 86-98.

Malhotra, M./CGAP (1997), "Microfinance: the new emerging market?", CGAP Newsletter No. 3, Consultative Group to Assist the Poorest, Washington, DC.

Mazzorol, T. (1998), "Critical success factors for international education marketing", *International Journal of Educational Management*, Vol. 12 No. 4, pp. 163-75.

Nunes, P.A.L.D. (2002), "Using factor analysis to identify consumer preferences for the protection of natural areas in Portugal", *European Journal of Operational Research*, Vol. 140 No. 2, pp. 499-516.

Rungasamy, S. *et al.* (2002), "Critical success factors for SPC implementation in small and medium enterprises: some key findings from a survey", *The TQM Magazine*, Vol. 14 No. 4, pp. 217-24.

Sureshchandar, G.S. *et al.* (2002), "Determinants of customer-perceived service quality: a confirmatory factor analysis approach", *Journal of Service Marketing*, Vol. 16 No. 1, pp. 9-34.

Thiagarajan, T. and Zairi, M. (1998), "An empirical analysis of critical factors of TQM. A proposed tool for self-assessment and benchmarking purposes", *Benchmarking for Quality Management & Technology*, Vol. 5 No. 4, pp. 291-303.

Upneja, A. and Dalbor, M.C. (2001), "An examination of capital structure in the restaurant industry", *International Journal of Contemporary Hospital management*, Vol. 13 No. 2, pp. 54-9.

Zhang, Z. *et al.* (2000), "An instrument for measuring TQM implementation for Chinese manufacturing companies", *International Journal of Quality & reliability Management*, Vol. 17 No. 7, pp. 730-55.

Ziamou, P(L) (2002), "Commercializing new technologies: consumers' response to a new interface", *The Journal of Product Innovation Management*, Vol. 19 No. 5, pp. 365-74.

Appendix

List of the factored success items

The success (MEP, 2002, survey) items are arranged in descending order of factor loadings, with first item being one with highest loading.

Factor 1: Extent of formalization & transparency in financial reporting [*5 items*]

Question 27 Extent to which MFIs is a formal organization
Question 40 Adequacy of cash flows to service commercial loans
Question 4 Portfolio quality
Question 23 Availability of audited accounts
Question 3 Availability of relevant information

Factor 2: Viability of investment in microfinance [*3 items*]

Question 5 Returns achievable from investing in microfinance opportunities
Question 15 Credit rating score
Question 45 Total cost of borrowed funds, i.e. repayment burden and other costs

Factor 3: Microfinance practice and extent of product-delivery innovations [*6 items*]

Question 17 Extent of product and delivery innovations, technologies pursued
Question 14 Total number of clients
Question 50 Extent to which ethical image, social responsibility drives decision
Question 34* Lender's exposure and appreciation of microfinance operations
Question 33 Location of MFIs business
Question 16 Extent to which ethical image, social responsibility drives decision
*Means double loading

Factor 4: Operational reputation and stage of development [*7 items*]

Question 32 Ownership; including mix and composition of stakeholders
Question 30 MFIs stage of development
Question 36* Degree of MFIs operational autonomy from external influences
Question 9 Reputation risk of institution in previous borrowing
Question 38 Lender's strategy and financing policy
Question 18 Financial sustainability level (profitability track record)
Question 34* Lender's exposure and appreciation of microfinance operations

Factor 5: Extent of financial market reform and enabling environment [*5 items*]
Question 49 Extent of development of financial markets
Question 51 Financial sector liberalization, including supportive banking reforms
Question 48 Stable macro-economic environment
Question 52 Availability of appropriate financial instruments
Question 2 Size of MFIs

Factor 6: Sound financial management and good governance [*8 items*]
Question 20 Sound financial management practices
Question 22 Reputable board and good/effective governance
Question 19 Legal personality status
Question 8 Proper record keeping and adequacy of financial reporting system
Question 43 Exposure to commercial sources of funds and networking advantage
Question 29 Ability to meet customer demand with appropriate products
Question 12 Availability of appropriate and experienced management team
Question 36* Degree of MFIs operational autonomy from external influences

Factor 7: Secure Loan default risk [*2 items*]
Question 7 Possession of adequate (type) collateral
Question 28 Cost of making loans to MFIs, i.e. screening, administration costs

Factor 8: Sparse and limited donor funds [*4 items*]
Question 44 Inadequate supply of subsidized finance to the MFIs
Question 13 A formal business plan for marketing MFIs business strategy
Question 46 Lack of sufficient retained earnings
Question 39 MFI's commitment to poverty lending strategy

Factor 9: Transformation for funding access [*2 items*]
Question 25 Purpose of funds
Question 10 Supervision and regulatory status

Factor 10: Commitment to privatization and shareholding exposure [*2 items*]
Question 21 Extent of MFIs openness and acceptance of intrusion by investors
Question 41 Years of existence, i.e. long track record

About the authors

Nicholas Biekpe is a Visiting Professor of Development Finance and Econometrics at the University of Cape Town Business School, and Professor of Development Finance and Econometrics at the University of Stellenbosch Business School. Nicholas Biekpe is the corresponding author and can be contacted at: nicholas@africagrowth.com

Josephat M. Kiweu is a PhD Student at the University of Stellenbosch Business School, South Africa.

This article has been cited by:

1. NkundabanyangaStephen Korutaro, Stephen Korutaro Nkundabanyanga, AkankundaBrendah, Brendah Akankunda, NalukengeIrene, Irene Nalukenge, TusiimeImmaculate, Immaculate Tusiime. 2017. The impact of financial management practices and competitive advantage on the loan performance of MFIs. *International Journal of Social Economics* **44**:1, 114-131. [Abstract] [Full Text] [PDF]
2. Peter W. Muriu, Victor Murinde, Andrew William Mullineux. Reflections on Microfinance 109-159. [Crossref]
3. Md Aslam Mia. Determinants of Total Factor Productivity in Microfinance Institutions: Evidence from Bangladesh 197-222. [Crossref]
4. Bob Ssekiziyivu, Rogers Mwesigwa, Mayengo Joseph, Isaac Nkote Nabeta. 2017. Credit allocation, risk management and loan portfolio performance of MFIs—A case of Ugandan firms. *Cogent Business & Management* **4**:1. . [Crossref]