

**Sector
Highlight**

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**Microfinance Investment Opportunities
in an Under-Banked Cambodia**

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In recent years, the Cambodian banking sector has experienced dramatic growth due to annual GDP expansion of more than 10 percent and increasing bank penetration. Bank deposits have grown from \$382 million in 2000 to more than \$2.5 billion today while bank loans have increased from \$310 million in 2000 to more than \$2.5 billion. However, Cambodia still remains relatively “unbanked” with total bank assets less than 40 percent of GDP as compared to approximately 160 percent in Korea and 80 percent in Vietnam.

Most Cambodian commercial banks have traditionally focused on the top 20 percent of the economic pyramid and have overlooked rural communities that comprise more than 80 percent of the overall population. Microfinance institutions (“MFIs”) have played a critical role in filling this gap by delivering financial services to low-income households and micro enterprises that generally do not have access to formal financial institutions.

The Cambodian microfinance sector is generally considered a model microfinance industry and is widely studied by academics and banking professionals. Five Cambodian MFIs are included in the *MIX Global 100 Composite Rankings* of the top 100 global MFIs. Only India has more MFIs in the index. At the end of 2008, Cambodia had 18 licensed MFIs, up from six MFIs in 2003 and zero in 2000. In addition, there are approximately 25 MFIs registered as rural credit operators. A licensed MFI is required to have a minimum registered capital of KHR 250 million or approximately \$62,500.

The evolution of Cambodia’s microfinance sector can be traced back to the late 1980s and early 1990s when a number of non-governmental organizations (“NGOs”), with roots in the Cambodian refugee camps in Thailand, began offering credit to micro-entrepreneurs (initially de-mobilized soldiers) as part of integrated rural development programs. The majority of Cambodia’s existing MFIs have been transformed from international aid organizations or NGOs. Although these organizations embrace the financial sustainability of the microfinance model, many of these MFIs still strongly protect their social mission. Currently, there are an additional 90 NGOs also supplying credit in rural areas through a “village bank” model that typically includes 100-200 members managed by a village credit committee.

Microfinance loans increased by 61 percent in 2008 and are expected to grow by 10 to 20 percent in 2009. In 2008, the number of MFI borrowers exceeded one million, up from 970,152 in 2007. According to the Cambodian Microfinance Association (“CMA”), microfinance loans totaled US\$740 million, comprised of \$438 million from 17 microfinance institutions and \$302 million from The Association of Cambodian Local Economic Development Agencies (“ACLEDA”) Bank PLC, one of Cambodia’s largest commercial banks with a strong emphasis on microfinance. CMA claims that Cambodia’s microfinance institutions have a low portfolio risk of less than 0.7 percent or \$3 million.

Microfinance loan products consist primarily of fully collateralized individual loans, group loans, and village banking that provides loans to poor entrepreneurs in rural areas and small businesses in urban areas. Group loans are generally made to groups of two to ten members. Each group member takes loans of \$12.50 to \$500, but collectively the total loan is less than \$1,500. These loans are typically non-collateralized loans where all members of the group have to guarantee the loans of the others in the group. The group must be formed by people who live in the same village or area but come from different households. Although collateral is not required, each member of the group must have

his or her own assets such as animals, motorcycles, machines or other durable goods. Some MFIs also provide consumer financing and other types of loans, but overall Cambodian MFIs have yet to diversify product lines and focus almost exclusively on small business loans. Immovable assets such as land are typically required as collateral for individual loans while cash-flow lending has been very slow to gain traction in the industry. Collateral-based lending by MFIs, as well as commercial banks, has been somewhat constrained by the lack of a comprehensive land titling system.

Interest rates are typically around three percent per month which are less than what is available from village money lenders. Historically, approximately 70 to 80 percent of microfinance customers have been women (primarily married women). Women apparently are more likely than men to be entrepreneurs and historically women have often taken the lead in managing the household's finances. Nonperforming loans have been lower for MFIs than those found in the banking sector. Economic conditions and a strong Buddhist culture in rural areas (belief non repayment of loans may result in punishment in next life) have been contributing factors. Through the utilization of group loans and joint liability loan contacts, MFIs have also been able to create a system of "social collateral". The high interest rates and low rate of non-performing loans compensate for the high costs associated with administering many small loans through a nationwide network.

The majority of microfinance capital, both equity and debt, is provided by international investors. It is estimated that as much as 80 percent of Cambodia's microfinance capital comes from abroad. Existing banking regulations treat MFIs more like specialty banks or non-bank corporations than commercial banks and therefore limit their ability to raise deposits.

The microfinance industry is expected to face slower growth and higher interest rates in 2009 as foreign investors scale back their emerging market investments. Nonperforming loans will also likely increase as a result of slower economic growth, especially for loans associated with the garment industry and other export dependant businesses. However, there are indications of sustainable domestic growth. Although the Cambodian government has only recently allowed MFIs to apply for licenses to begin accepting deposits, Cambodians are beginning to show signs of a willingness to embrace savings accounts. Traditionally, poor Cambodians have chosen to invest excess capital in their homes and livestock. However, Cambodians are now saving more with MFIs. This trend is expected to continue as MFIs introduce improved products and trust in the overall banking system increases. In the long run, increased access to capital through deposits will hopefully counterbalance declines in foreign investment as a result of the financial crisis. Demand for microfinance loans remains strong as MFIs are the only financial services available for most of Cambodia's population. Therefore the availability of funds to lend is the only potential constraint for future growth.

ACLEDA is the leader in the Cambodian microfinance industry. ACLEDA was founded in 1993 with the support of the United States Agency for International Development, United Nations Development Programme, International Labour Organization and the World Bank as a national NGO for micro and small enterprises development and credit. The Board of ACLEDA and its sponsors decided to convert the NGO into a specialized bank in 2000 and into a full commercial bank in 2003. Today, ACLEDA is one of Cambodia's leading banks. ACLEDA is one of the few microfinance specialists whose loans are financed largely by customer deposits. It has the largest banking network in Cambodia with 226 offices and a presence in all 24 provinces with approximately 6,000 employees. ACLEDA recently expanded to Lao PDR with the opening of three branches and is one of Cambodia's strongest candidates to list on the Cambodian Stock Exchange once it is launched. ACLEDA had net income of \$16.8 million for the first nine months of 2008 and total assets of \$697 million as of 30 September 2008. Other large MFIs include AMK, AMRET, HKL, PRASAC and Sathapana Limited.

Consolidation in the Cambodian banking sector is expected over the coming 12 to 20 months as a result of the National Bank of Cambodia's tripling of the minimum capital requirement in September 2008. Capital requirements were increased for commercial banks from KHR 50 billion (\$12.5 million) to KHR 150 billion (\$37.5 million) and for specialized banks from KHR 10 billion (\$2.5 million) to KHR 30 billion (\$7.5 million). Banks existing prior to September 2008 have until the end of 2010 to meet the new capital requirements. Microfinance insiders also predict significant consolidation in the



microfinance industry. Although some rural markets remain virtually untapped, other markets are beginning to reach a saturation point. In addition, there is a significant discrepancy in the loan portfolio size of the top 50 percent and bottom 50 percent of MFIs. Consolidation will be required to reach scale and make existing MFIs more commercially viable. This trend is expected to accelerate as more commercially-minded and active equity investors enter the market. The industry may not only change through mergers and acquisitions, but it may also be reshaped as some larger MFIs attempt to follow the ACLEDA model and apply for commercial banking licenses that will allow them to maintain lower liquidity and solvency ratios.

Emerging technologies and initiatives such as mobile banking may also play a role in altering the dynamics of the microfinance industry. In January 2009, Australia and New Zealand Banking Group (ANZ) launched WING, a new branchless banking service targeting rural Cambodians. The mobile phone money transfer service allows rural Cambodians to make low-cost person-to-person payments and transfers directly from their mobile phones. MFIs are expected to incorporate mobile banking as a means of loan disbursement and repayment. Such initiatives should allow for lower distribution costs and greater outreach.

Microfinance institutions have particularly strong networks in villages and urban centers outside of Phnom Penh, Siem Reap and Sihanoukville. In many cases, they have wider national reach than most commercial banks. It is estimated that more than 70 percent of Cambodian borrowers are microfinance borrowers. Limited credit information sharing makes the internal records on customer creditworthiness that MFIs possess extremely valuable. An investment in an MFI offers the opportunity to tap into the tremendous growth opportunities in the agriculture, commodities and food processing, rural electrification, rural infrastructure and rural tourism development sectors.

Leopard is currently evaluating several options to participate in the sector. These include participating in any pre-IPO capital raising by ACLEDA, acquiring an existing MFI or merging an existing MFI with a smaller commercial bank.