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Leveraging Donor Funds:

The switch to commercial sources of funding

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Abstract

Sustainable livelihood strategies in microfinance are a major force behind enterprise development in poor societies. But uncertainty of continued donor funding poses a risk to operations. This paper presents findings on, critical success factors that define minimum pre-conditions for microfinance institutions considering commercial funding as an alternative. The study is conducted on broad-based industry experts responsible for making funding decisions. Paper explores what it takes to finance MFIs through leveraged funds and argues that key transitional factors are critical for a successful switch to commercial funding. A realistic checklist for self-assessment of MFI's progress in a commercialization strategy is proposed.

JEL classification: O16; O 19; N8; F34

Keywords: Critical success factors; Commercial funding; Fund markets; Donor funding; Commercialization.

1. Introduction

It has long been stated that funding is a major constraint in microfinance. It slows the growth and expansionist activities of this 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 the additional capital they need.

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; KIPRRA, 2001). We propose a financing strategy for MFIs seeking additional financing for their credit programs.

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. 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.

The purpose of this paper is to establish the importance commercial-lenders'/investors' attach to various factors relevant for financing reformation (migration) of the microfinance industry. It examines the factors that influence the decision to finance microfinance operations. Appropriately identifying critical success factors (CSFs) from the perspective of commercial lenders provides MFIs with valuable guiding principals for attracting commercial funding. CSFs provide a means of assessing and building up an MFI's competitive ability over the rivalry for scarce funds.

Recently, there has been an increasing interest in the financial markets as a source of finance for microfinance. Lenders' perceptions of the critical performance factors for increased use of commercial funding are key determinants of the success and adoption of commercial microfinance. However, many MFI managers do not understand the most important factors that drive successful attraction of commercial funding. Therefore, an investigation of critical success factors for implementation of commercial microfinance was worthwhile to carry out.

Specifically, the author conducted a survey focused on the perceptions and experiences of lenders at industry-level, with the aim of discovering the factors that bring success in a commercialization strategy. The results indicate ten- (10 CSFs) key requirements that improve the potential for success in tapping commercial markets. We develop an exit strategy; away from 'captive' donor funding and underscore the role of commercial intermediation. Our results contribute to the body of knowledge in development finance and resource planning. The findings provide insight on success strategies associated with commercial lending and a useful financing planning tool for MFIs seeking additional funding.

2. The 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.

The microfinance initiative started with two objectives: first to provide financial services targeted to the poor and other vulnerable groups in society, and secondly, to provide access to credit for social and economic empowerment. The best-known part of microfinance, micro-credit (Labie, 2001) has been used over the years to finance and promote small and micro-enterprises. Microcredit for enterprise development and income generating activities attracts much of its funding from donors and subsidized state run credit schemes.

Micro enterprises and credit schemes have witnessed enormous growth. This has constrained the financing resources of their partners in development (MFIs, informal sources, donors and government agencies), with serious implications to their survival and sustainability. Microfinance institutions themselves seem to be in dire (distressing) want of refinancing from alternative sources. Hence, the increased interest for development financing, by the commercial markets in recent years.

The method of financing microfinance has been a fundamental issue of concern. It is believed that it poses a threat to sustainability of programs and creates inefficient operations. Nevertheless, the sustainability debate and adoption of best (sound management) practices by most institutions in the industry has fueled the emergence of efficient MFIs. Leading NGOs and MFIs have considered alternative sources of finance, because of their ability to deal with microcredit on a market basis (Carlos and Carlos, 2002; Labie, 2001).

Thus far, MFIs have consolidated their mission/vision, and perfected their delivery processes and approach to microfinance. As they grow and expand their need for external funding increases by the day. In its expansion stage, a company that has established its products in the market place becomes a candidate for external funding (Jeng and Wells, 2000). However, the approach to solving financing constraint in microfinance has always been inward looking, and never outward. This underscores the need for an exit strategy; away from 'captive' donor funding that has characterized the industry.

Current financing approaches in microfinance have neither identified nor emphasized the factors that matter in accessing alternative commercial funding. To keep the improvement momentum and sustain achievement of MFI mission for the poor, commercial finance needs to be encouraged for three main reasons: it offers long term growth funds, leverages scarce donor funds and ensures sustainable development of microfinance. This source if well developed has the capacity to fuel and support microfinance as well as give it the final breakthrough to reach a wider section of the poor.

This paper underscores the importance of commercialization and shows the relevance of its contribution to the furtherance of the aims and objectives of the microfinance initiative. *Commercialization* is defined as the funding of an MFI's expansion operations and lending portfolio with commercial finance. The process of commercialization started in 1996/7 – when industry players started mobilizing support from financial markets/commercial lenders, after realizing 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 crucial role commercial actors can play in microfinance development, especially in supplying vast sources of money. It has also been established that it is possible to fund microfinance through investor finance, after successful trials and experiments (Hattel and Halpern, 2002). Commercialization may be attributed to a variety of factors that influence its success as a strategy for innovative sources of microfinance. But of particular concern are those factors that define the critical path to success.

While donations represent an important source of funding for microfinance, their scope is limited to the development agenda/policy of the donor. In the past, this has been shifting, adversely affecting the funding environment. Identifying factors[1] that enhance successful attraction of leveraged funds could potentially reduce the funding constraints of MFIs. We develop an understanding of lending requirements (or qualifying criteria) of the financial markets as an alternative source of finance. These criteria give MFIs a platform for achieving success. We argue that adoption of success strategies in accessing financial markets can 'shape the future' of microfinance.

The emerging commercial market needs to be promoted to become a dependable source of capital for MFIs seeking financing. Given the growing scarcity of donor funds and the increasing competition for funding in the 'donor industry', it is necessary to develop effective strategies for fruitful interaction with alternative fund markets. Failure to promote alternative funding sources could prove catastrophic to organizations seeking to grow, and threaten their continued existence. Their role in development will also be greatly curtailed.

The association with financial markets will yield special value to MFIs that successfully attract such funds (Jain, 2001). Commercial lenders will provide more than just money to microfinance: increased transparency, enhanced credibility and a positive signal to fund providers about the MFI. The incoming of commercial lenders will therefore not only provide capital but also reputational[2] intermediation (Black and Gilson, 1998). Hence a major role that commercial finance can play is to establish credible borrowing reputation, encourage good management skills and build a refinancing capability for profitable operations of microfinance. This could be the final switch for the establishment of a funding relationship with the larger formal financial system.

This financing option will facilitate MFI growth and accelerate economic development in poor communities; as well as ensure effective and efficient utilization of the worlds resources. A commercial financing strategy leads to a realignment of capital flows and

[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.

evens-out global resource sharing. As commercial lenders gain the willingness to finance microfinance MFIs need to tap these vast resources to circumvent liquidity constraints.

2.1 Challenges to Commercialization

MFIs present emerging growth opportunities and business concept[3] to the entire finance system. Rapidly growing firms often want to use external financing (Upneja and Dalbor, 2001; Burger and Udell, 1998). By and large, commercial funding is not optimal, but can be optimized to play a key role in financing fast growing MFIs with unused debt capacity. However, a solid foundation is required for a winning commercialization strategy.

The philosophy of commercialization as a model for sustainable financing of MFIs is based on business ideals and practices that define a minimum development level for success. From a broad view, some MFIs have: identified a growing market with potential, developed expertise and appropriate personnel competencies, developed products/services that clearly fulfill a need in the marketplace, and achieved high levels of innovation in their business model. This enterprise development process is a necessary prerequisite for going to the capital markets (Jain, 2001).

Commercial lenders deem it costly to lend to microfinance and as a result find it difficult to create an interest for the market. The costs are due to information asymmetry for selection of viable institutions, informal nature of the organizations, low efficiency reputation and NGO culture, the cost of loan administration, screening costs and information gathering, monitoring costs due to poor business infrastructure 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 in order to reduce uncertainty about the new innovation performance. Microfinance has dealt with the first issue quite successfully by popularizing best practices in the industry. However, the second challenge is a great detriment to its progress and has slowed the adoption of commercial 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 studies, there has been very little studies done to reflect the perspective of the financial markets. We suggest this as the 'missing connection' to the vast money markets. MFIs

[3] With promising delivery technology

need to understand what alternative fund markets require and attain necessary capacity to engage them. Then, the capital flow can begin!

The primary focus of this paper is to highlight (showcase) the factors commercial lenders/investors believe are crucial for effective loan contracts with MFIs. For MFIs adopting commercial microfinance, necessary pre-screening strategies can guarantee good performance on meeting requirements and satisfying commercial lenders' concerns. Failure to promote commercial loans in microfinance has lead some to believe development finance can only come from donors and well-wishers. But, given the need to leverage donor funds, commercial finance can be made suitable for microfinance.

Given successful performance of MFIs that have attempted to take a share of global financing resources (Malhotra/CGAP, 1997), it shows that a clear strategy for commercialization of microfinance backed by supportive financial intermediation can yield excellent results. It is the intention of this paper to define and develop strategies that enhance, and guide MFI's potential for success in raising risk capital.

3. The critical success approach

The critical success approach is an accepted method for corporate strategic planning (Chen, 1999). The method aims to identify factor structures present in a set of variables (Child, 1970). It is based on the technique of factor analysis. Factor analysis identifies relatively 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 critical success factors 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 Critical success factors (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.

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'. This is an important step in understanding the building blocks for MFI-commercial market interaction.

The relevance of the CSF approach is seen in its ability to aid preliminary screening of MFIs suitable to pursue commercial microfinance. Fund providers will use CSFs to assess and separate investment portfolios they would want to target for financing. 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.

Lack of understanding of performance expectations of commercial lenders leads MFIs to prematurely go to the markets, thereby risking rejection (Jain, 2001). Hence besides the need to develop a sufficient track record for MFIs, we need to define CSFs that are necessary prerequisites for successful attraction of commercial markets.

Chen (1999) derived four CSFs in the banking industry reflecting the business goals for the bank manager: 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, Mazzoral (1998) identified four underlying dimensions. These were promotion and recruitment, image and resources, people and culture, and, coalition and forward integration. In a consideration of credit criterion used for evaluating mortgage loans, Liu and Lee (1997) identified[4] 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.

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. Their list of the seven CSFs consisting of 38 items were as follows: Factor 1- training and education, Factor2- quality data and reporting, Management commitment, customer satisfaction orientation, role of the quality department, communication to improve quality and Factor 7- continuous improvement.

In this study, the factors used represent key information that is likely to be used for evaluating credit or screening. While we have a good indication of what commercial lenders demand to make decisions, we still are not sure how they prioritize among important considerations. CSF approach helps rate importance attached to a set of evaluation criteria used by industry players.

The research design stresses factors in the context of banking industry and microfinance, and emphasizes the adoption of appropriate performance standards befitting the formal commercial sector. From a set of 53 potential success factors we identify and highlight the CSFs for accessing commercial funding. MFI management has a crucial role to play by controlling and successfully managing performance in areas of interest to fund markets. This is a strategic step facing MFIs that would want to bring their organizations to the market.

[4] Rungasamy et al. (2002) analyzed 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. Research Methodology and data collection

The method used was perceptions' and experiences of people involved in commercial microfinance in the industry worldwide (Thiagarajan and Zairi, 1998). Although the individual is the unit of analysis, the study design enables assessment of organizational practice as a whole. The target group was drawn from informed international players committed to promoting commercialization of microfinance.

Data was 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. The questionnaire was designed to measure the individual's perception of the relative importance of a set of factor considerations used in commercial lending decision.

4.1 Survey design and Success factor determination

The literature provided an applicable list of potential success factors (items in the survey document) 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[5] began 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, to improve content and face validity of the survey items (Kelsey and Bond, 2001, Sureshchandar et al., 2002). This exploratory approach was intended to unearth and ensure a complete list, providing adequate representation of the conceptual domain (commercial lending practice criterion), given the little research done on information requirements of commercial lenders. A final list of 53 potential success factors of MFI access to commercial funding was collectively identified.

The Microfinance Experts Panel (MEP) 2002survey document consisted of three parts: Part one contained the 53 factors and was sectionalized into factors relating to the

[5] This exercise included the author's detailed analysis of relevant literature in prescription and conception of potential factors (based on field experience) augmented by additional factors obtained from discussions with experts and case studies in microfinance.

lenders' perspective, MFI demand factors, and external environmental factors. Part two consisted of question number 54 meant to test completeness of the dimensions of commercial microfinance. In recognition of the disparity of evaluation criteria, question 55 sought to find out the respondents' experience of the five most important considerations in lending practice.

4.2 Sampling procedure and Survey framework

Simple stratified random sampling was applied on a broad-based group of industry 'experts' representative of proponents of commercial microfinance, from operational regions in Africa, Asia, Americas and Europe. From each region a number of experts were randomly selected. The sampling process was augmented with the author's scan to ensure industry coverage. This group formed the respondents of the MEP 2002survey instrument.

The population was defined as proponents of commercialisation and interested commercial actors in microfinance. The sampling frame for the MEP panel consisted of the following sources. Main pool was Commercialisation Conference attendees list[6]; Active investors' (both social and development) list[7] for Africa region, Approved and accredited microfinance Rating agencies (CGAP accreditation), Key donor agency's/Networks' staff, Development Consultants and technical Advisors on microfinance policy.

In the study, the 'experts' were asked to indicate the importance of each of the 53 potential success items on a Likert scale of 1 to 4, ranging from "Not important" to "Very Important" respectively. A rating of "0" on the scale provided for non-response or "No Opinion" – which was also a measure of item inappropriateness/validity of the item. The Likert measurement examined the respondent's perception and experience of each item's importance rating to commercial lending decision.

The survey used a 'personal contact approach'[8] in collecting the views of informant respondents (Madill et al., 2002; Sureshchandar et al., 2002). The sample constituted persons responsible for lending decisions as much as was possible to ascertain. A total of 117 emails were sent to MEP experts in 17 countries 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 of 44 respondents committed to participate in the survey after periodic follow-ups. Securing agreement to participate was not easy. The MEP

[6] Held in New York, 2001
[7] See CGAP website
[8] 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.

2002survey document was sent to the 44 experts in the sample, with clear instructions. A final usable sample of 36 replies was returned representing 30.7% response rate.

5. Analysis and Survey Results

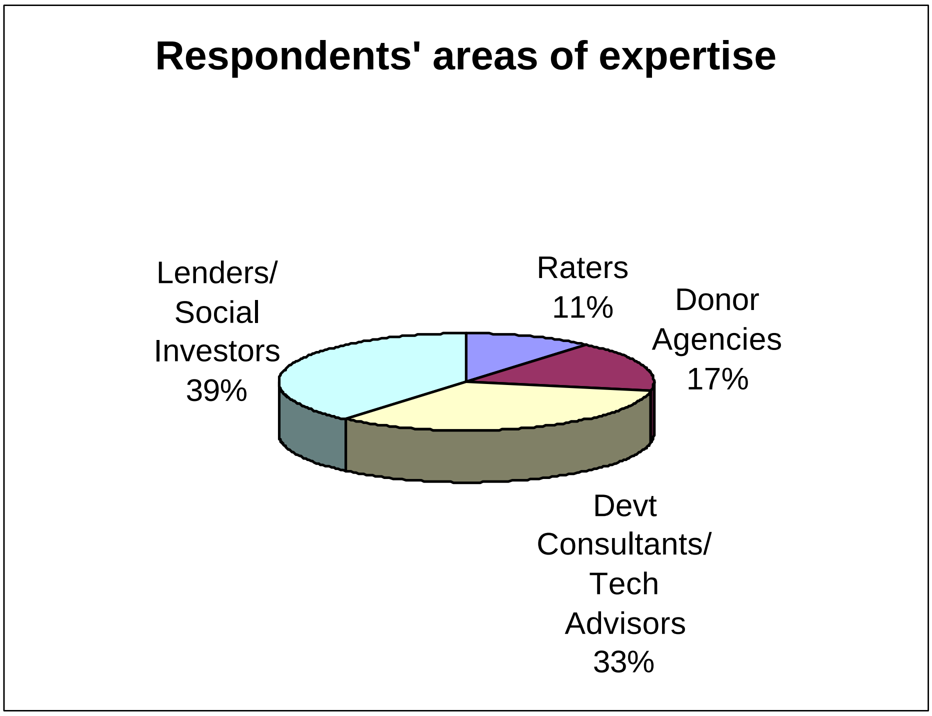
Table I shows the number of countries in each region, and corresponding respondents who participated in the study. About half (8) of the participating countries were based in Africa, 3 in the Americas, Asia and Europe, a factor that needs to be taken into account in considering the generalization of our results. The findings indicate majority (61 per cent) of the respondents were linked to microfinance programmes in Africa.

No. Of countries/ Respondents	COUNTRY REGION 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

The analysis of the questionnaire responses showed that the highest number of respondents (about 40 percent) were lenders and social investors. An interesting[9] group of experts was the approved microfinance rating agencies, which are currently providing creditworthy ratings for funding. The percentages of the respondents' areas of expertise are shown in Figure 1.

[9] Majority of the raters participated in the survey (60 per cent). This group has been in the forefront in promoting commercial funding by providing the link between different capitalists and the industry.



The analysis of what follows has been performed to determine how the respondents rate the 53 factor items. The importance rating is listed in Table II. First, the mean scores of the Likert ratings were computed. The individual mean value was used as an indicator of the item's importance, without regard to other items (Chen, 1999; Rungasamy et al., 2002; Mazzarol, 1998). A factor item with the highest mean score is considered as the most important factor and one with the lowest mean score the least important.

The highest value on the rating scale was 4, representing "very important". It can be seen in Table II that majority of the respondents consider "Availability of relevant information", as the most important evaluation criteria in a lending decision. This is 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. Results of mean score importance rating

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 microlending	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

In the fourth column of Table II, we find that most of the success factors were rated below 3.00- i.e. below the "important score". Interestingly, MFIs commitment to poverty lending strategy, unused debt capacity, and location of MFI are found at the bottom of the list meaning they do not matter in attracting commercial funds. This is to be expected, since all that matters is whether lenders get their money back!

5.1 *Exploratory Data Analysis*

A factor analysis was undertaken of the 53 success factors to identify the critical factors of MFI access to commercial markets. The general purpose of factor analysis was to summarize the information requirements for commercial lending. The analysis proceeded in an exploratory mode[10]- an approach used in the absence of detailed theory (Zhang et al., 2000; Sureshchandar et al., 2002).

Factor analysis was done using statistica computer package version 6.0 and principal component extraction method (Antony et al.2002; Mazzarol, 1998). As per principal component analysis, only factors having eigenvalues greater than 1 are considered significant (Herman, 1976; Child, 1970; Chen, 1999). A varimax rotation was applied for ease of data interpretation and determination of common factor structures, with maximum factor loadings (Hopkinson and Pujari, 1999). Factor loadings under each critical factor (qualifying factor structure) were used to provide the cut off for items to be considered.

In this study, the cut-off point for success factor interpretation was + 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

[10] 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.

(Antony et al., 2002; Zhang, 2000; Hopkinson and Pujari, 1999). High factor loadings suggest[11] that the factors are critical (Antony et al., 2002; Chen, 1999; Nunes, 2002).

In keeping with this ruling we derived 10 factors, thus omitting 11 success items that did not score above + or - 0.55 - meaning that only 42 items were suitable for factoring. Table III shows the final ten factors wherein all factors have more than one eigenvalues, accounting for 85 percent of variance in the data. As per Kaiser's criterion, only factors having eigenvalues greater than 1 are considered significant for extraction. All 42-factor loadings yielded clear results with statistics ranging from 0.56 to 0.92. The results are reported in Table IV.

5.2 *Interpretation of 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.

Table III. Number of factors and eigenvalues

	Eigenvalues (Spreadsheet4) Extraction: Principal components			
Value	Eigenvalue	% Total variance	Cumulative Eigenvalue	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

The ultimate importance of factors is determined by their interpretability. It should be noted that the success items (questions) 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.

[11] Other factor loadings are considered insignificant and can safely be dropped in the selection process.

Factor 1 collects five success items that deal with issues related to ability of MFI operational structures to produce reliable and transparent financial information. That is, audited accounts, portfolio quality, adequacy of cashflow/ability to repay, and appropriate - formal and accountable operational structures. Formalized operations allow for proper accounting of key information. Thus, we labeled factor one as "*Extent of formalization & transparency in financial reporting"*. This factor 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.

Factor 2 was loaded onto by three items that refer to assessment of business risk and creditworthy of an MFI. They include:

1. Returns achievable from investing in microfinance operations,
2. Credit rating score,
3. Total cost of borrowed funds, i.e. repayment burden and other underwriting requirements. Factor 2 was named "*Viability of investment in microfinance*".

Factor 3 includes six items that focus on microfinance outreach innovations. The items is include the: Number of clients, Location of MFI business, Extent to which ethical concerns and social role of lender drives decision to lend, Lender's appreciation and exposure to the role microfinance in economic development. Product delivery innovations pursued by the MFI and Availability of development funds targeting microfinance. 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. They include: reputational risk of the institution in previous borrowing, profitability track record, MFI stage of development, ownership mix, lender's exposure to microfinance operations, degree of MFI operational autonomy, and finally, lender's financing policy. 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.

1. Stable macro economic environment,
2. Extent of development of financial markets,
3. Financial sector liberalization and supportive banking reforms,
4. Availability of appropriate financial-intruments for microfinance institutions,
5. Size of MFI, which is a function of the operational environment.

These items represent external environment factors conducive for the practice of microfinance. Factor 5 can be named *" Extent of financial market reform and enabling environment".*

TABLE IV. RESULTS OF ROTATED FACTOR MATRIX

Variable (Var.), Success items	Mean Score	Significant factor Loadings only, F= Factor structure										Total/ Var. /F
		F1	**F2**	**F3**	**F4**	**F5**	**F6**	**F7**	**F8**	**F9**	**F10**	
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	3.72					(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	3.50							(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**

*Total scaled down by 2 items which loaded onto two factors, I.e. Qn 34 & 36

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*". The list is as follows:

1. Proper record keeping and adequacy of financial reporting system,
2. Quality of management; suitable and experienced personnel,
3. Legal personality status of the MFI,
4. Sound financial management,
5. Reputable board and effective governance,
6. Ability of MFI to meet customer demand with appropriate products and services,
7. Degree of MFI operational autonomy - free from external influence and,
8. MFI exposure to commercial sources of funds and networking advantage.

Factor 7 loaded only two items. The two loan items refer explicitly to lending methods in microfinance. That is, the cost of making small loans to MFIs and adequacy of collateral to secure loan advances. Note that in Table III, the factor loading for adequate collateral (the key item) is negative and the highest in the analysis. This reflects the fact that lending in microfinance is not constrained by lack of collateral. It is not expected, but the lack of it is a critical strength in micro lending!

We interpret it to mean other loan guarantee mechanisms work and are more acceptable in microfinance. The higher factor loading is indicative of respondent's view that, lack of collateral does not bother them. This is suggestive and recognizes the high repayment rates - low default rate, on record in microfinance lending. Therefore, factor seven is titled " *Secure Loan default risk*". This means, lenders expect MFIs to confirm (guarantee) low default rates and ensure good performance of loans through their innovative lending and guarantee mechanisms.

Factor 8 contains four items relating to sources of funding and fund raising methods. Items that load on this factor are (1) a formal business plan for marketing MFI business expansion strategy, (2) MFI's commitment to poverty lending strategy - including pro poor demand based product offerings, (3) inadequate supply of donor funds and, (4) lack of sufficient retained earnings. 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). Availability of easy (cheap) money 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, many MFIs hold 'funding purpose' as the main reason for transformation into 'conventional' legal forms. Financiers consider the legal form of many MFIs not promising. Besides, in many countries an institution can not be allowed to take deposits (a cheap source of funding for MFI), unless it's regulated. Understandably, there is wide spread rush to transform as away of moving towards commercialization and growth.

Finally, *Factor 10* contains two success items relating to managerial ownership retention, i.e. extent of openness and acceptance of intrusion by outside investors, and MFI's long track record - years of existence. 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 institutional growth. In other words, 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"*.

6. Discussion of Results

Our research has derived ten CSFs for raising additional funds from commercial fund markets. They reflect ten financing goals for microfinance institutions. They are:

	CRITICAL SUCCESS FACTORS by NAME	Importance Score	Priority Level
1.	*Extent of formalization & transparency in financial reporting,*	*3.56*	*1*
2.	*Viability of investment in microfinance,*	*2.82*	*6*
3.	*Microfinance practice and extent of product-delivery innovations,*	*2.38*	*4*
4.	*Operational reputation and stage of development,*	*2.84*	*2*
5.	*Extent of financial market reform and enabling environment,*	*2.77*	*5*
6.	*Sound financial management and good governance,*	*3.16*	*9*
7.	*Secure Loan default risk,*	*2.61*	*7*
8.	*Sparse and limited donor funds,*	*2.59*	*8*
9.	*Transformation for funding access,*	*2.66*	*10*
10.	*Commitment to privatization and shareholding exposure.*	*2.50*	*3*

Table V. Description of Critical success factors

Some of the findings may seem obvious, but what is clear is that many MFIs are confused by diverse and often conflicting initiatives, with no particular reason why such efforts should succeed. Much struggle has been devoted to areas that make little difference[12], while CSFs for winning are overlooked. MFIs can increase their success rate if they put more effort in fulfilling demands which lenders/investors consider important for lending.

The selection of an investment/borrowing partnership in microfinance at the moment is a one way-matching problem. The investor or lender as the case may be incurs considerable risk and resources to evaluate a suitable organization. Specifically, commercial lenders go through a careful evaluation of a number of factors before

[12] A mere strive for survival

agreeing to do business with an MFI. The MEP 2002survey responses revealed: the factors they consider relate to management capability, governance issues, product uniqueness and delivery systems, growth potential, ability and adequacy of financial information, portfolio quality, and a host of other factors.

On their part, MFIs play a minimum role in the decision process. However, they now have to do some strategic posturing, to make themselves attractive to the right partners and also increase their negotiation power. 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.

Analysis and interpretation of the responses to the MEP questionnaire allowed objective judgment in reaching a consensus on perceived importance rating of success factors, a requisite to developing success strategies. 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 consolidated in the CSFs explain MFI success clearly and the implications which can provide useful managerial direction.

The CSFs make it possible for individual MFIs to study their situation and make note of their assessed scores in regard to these requirements. However, management must emphasize the principals inbuilt in these financing strategies to realize their benefit. A look at the CSFs themselves shows most of the factors are meant to orientate MFIs to commercial business practices that go to assist in reforming the industry's refinancing strategy.

In recognition of efforts of governments to support microfinance industry through conducive regulation proposals; many MFI organizations have moved towards commercialization of their operations. The intention is always to transform into a formal legal structure that offers potential for viable financing options. As the regulatory battle continues, one thing is clear, MFIs lack guidelines and known strategies for growth in this direction. This research fills this gap, and enhances a commercialization option, as well as allaying fears of potential capitalists.

First, commercial lenders decision to fund microfinance is met with uncertainty and lack of relevant information. This is the highlight of factor 1. In factor 2, we note that performance parameters are also another key requirement. Capitalist would like to know how viable microfinance is as an investment destination of their funds. This gives them a way of evaluating their opportunity costs. Secondly, in Factor 3 and 4, the practice of microfinance as an enterprise is under scrutiny. Industry players have developed sub-optimal measures to guide their decisions, leaving many would be actors with nothing to guide their actions or inaction. These factors reflect the requirements that MFIs need to set forth to commercial lenders. The number of clients, product innovation and delivery technologies pursued by the MFI, and the location of the MFI are certainly some of the facts that a lender would like to appreciate.

The factor titled "extent of financial market reform and enabling environment" comprises of factors that are out of the control of the MFI, but nevertheless crucial for success. For example, there should be financial instruments that are tailored to microfinance providing a contractual link with MFIs. If this is not available and is not supported by the banking system, then, financiers may find it difficult to enter into a financing agreement. Factor 8 on "sparse and limited donor funds" is worth of mention. As noted above, the MFI must admit that it has the necessity[13] for cash. This provides the required drive to seek capital from alternative sources.

A number of rating agencies have come up with methodologies that highlight performance deficiencies for management's focused attention besides financing recommendations. However, this service is not accessible to many organizations. The findings of this study (based on grounded research) supplement the efforts of creditworthy raters. But more importantly, offers a solid foundation for a winning strategy to attaining an investment grade. It is indicative enough from all the CSFs identified that MFIs seeking to open their operations to the public domain for funding, must attain certain performance conditions designed to woo prospective sources of development finance.

Note that we tested consistency between perceptions held by surveyed respondents and what they practiced. We find there is a direct correlation between factors perceived to be important and actual criterion used by lenders. Most respondents 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 shares most of the considerations sighted as evaluation criteria in the industry, by participating respondents.

The listed ten factors are not equally important, see ranking by mean scores for the CFS on Table V. We find that the first factor "*Extent of formalization & transparency in financial reporting*" contains success items that are highly rated in importance by participants. This is the most important CSF consideration in lending. It comprises more than half of the first five key success items, and two of the three most important considerations in Table II:

- Availability of relevant information,
- Portfolio quality and,
- Availability of audited accounts.

The background of these organizations can explain the importance of this factor. There is widespread information opacity. Thus, ability to refine the reporting system and avail information to support informed decisions is a success.

We single out the other important CSF as factor 6, i.e. "*Sound financial management and good governance*". This factor contains three success items in top six as per Table II.

[13] 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.

These items are providing necessary information to lenders/investors as key determinants of a credit evaluation decision. Proper record keeping and adequacy of financial reporting system is very reassuring to any investor. So is an appropriate management team and sound financial management practices. Using our measurement scale in the survey, these two factors alone pass the test of importance (a score of 3 and above) as can be seen in Table V. A rearrangement of the CSFs by mean score gives the implementation order of these strategies for success (see Table V for the prioritization).

6.1 Implications for Practice of Microfinance

It is now recognized that the broad objective[14] of microfinance ranges from poverty alleviation to micro and small enterprise sector development. The need to satisfy funding requirements for these objectives for practitioners is increasingly pressing by the day. However, 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).

In this paper we highlight the determinants of commercial funding growth in microfinance industry. The CSFs perspective seeks alternative measures that an MFI should take for increased access to financial markets. A comprehensive assessment and use of success factors in developing a financing strategy could allay the difficulties faced by MFIs in attracting funding. This is a right step towards alleviating constrained donor funds. Focus should now be given to areas that are important for achieving access to alternative funds, sustaining success in microfinance business and remaining relevant.

CSF provides the value of a finance-planning tool to obtain access to long-term financing for MFI's growth. They determine (set) priorities among success factors for MFIs. Adoption of CSF as a planning instrument for future financing will certainly lead to creation of a dynamic microfinance industry assured of sustainable growth. By and large CSFs aggregate microfinance experts' evaluation of factors that matter in a commercial lending decision. Besides, they will be helpful in effecting an equitable sharing of the world's resources.

From the perspective of a potential lender, CSF existence conveys a positive outlook of the MFI's long-term viability. CSF identifies critical conditions (performance expectations) in MFIs that help lenders/investors in making sound investment decisions. They serve to indicate critical requirements for commercial financing, and are an important mechanism for assessing the risk of funding microfinance prospects. Under the guidance of CSFs lenders will be more than willing to commit funds to microfinance, as the risk of getting their money back is minimized.

[14] Microfinance has in recent times operated with dual objectives: the traditional social objective and the emerging commercial objective.

Transparency brought by clear understanding from both sides will help change the reputation of microfinance to financiers. MFIs will no longer look at only on direction for funding, as they will be acceptable by the financial markets. The possibility of this link will mean gained access, and industry freedom from donor syndrome and precedence. This ‘communication’ breakthrough finally will provide necessary platform for the switch to commercial finance.

CSFs provide valuable guidelines and strategies for MFI financing integration with the larger financial system. From a management perspective, an MFI will be more focused and effective in fund raising, given the CSF understanding. Continued execution of CSF success strategies will open up the microfinance market to commercial lenders, development capitalists and the broad money market. This invitation enables (means) continued success of the microfinance enterprise in the longer term.

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/investors and potential capitalists with powerful decision-making tool. They make MFIs and development financial advisors aware of financing information requirements and implementation priority of crucial strategies for alternative funding. It is also an important reference for anyone (including researchers and academics) interested in the future of microfinance, and innovative financing strategies.

6.2 Inferences, Limitations and Future research agenda

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. A Preparedness Performance Index (PPI) with respect to each CSF is envisaged. The development of such an index would afford a gap analysis to be performed, given a matrix scale for full benchmark scores. This will allow management to realign critical success strategies and tactics to correct identified deficiencies.

Introducing the PP index of attractiveness would be appropriate as a benchmarking tool. 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 per CSF would give an indication on which areas an MFI is underperforming, and therefore needing more effort. 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 focussed. These indices would also help researchers to understand different facets of success requirements.

The imitations 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 programmes 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.

7. Conclusions and Future research agenda

The microfinance industry has experienced tremendous growth. This has been fueled by poor societies' eager to develop sustainable microenterprises 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.

We argue that possessing qualifying attributes determines ability to attract commercial funding, for MFIs seeking to raise funds from the financial markets. 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, 2001; Upneja and Dalbor, 2001).

Microfinance financing models relying and focusing on donor financing have limitations and are not able to reach more poor societies that are in dare need of financial services. The alternative-financing model presented in this paper explores what it takes to finance microfinance institutions at the cutting edge of enterprise development and market reforms. This model encourages investment in and development of microfinance, and identifies criteria used by commercial lenders and other capitalists when considering funding in an MFI. Model therefore offers an alternative, which leverages scarce donor funds.

The results of this study allow us to confirm the importance of transitional factors influencing the success or failure of the switch to commercial sources of funding. 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 that is backed by MFI's financial sustainability.

Given the growing shortage of donor funds (main traditional source of capital) the failure to develop effective success strategies to promote alternative funding sources will limit the potential for microfinance in economic development. The 10 CSFs highlighted in this paper provide a realistic checklist for self-assessment of MFI's progress in a commercialization strategy. This can be used as a pre-screening tool whose performance rating will control for disappointments that arise due to premature moves and improve on the levels of preparedness for commercial funds drive. Findings also suggest on prioritization of strategy execution.

The level of preparedness would be a useful benchmarking analysis, as a basis to prioritize areas for improvement action. Such an assessment would be important given the costs charged for creditworthy recommendation (rating) and lost funds in numerous funding appraisals. An institution performing to the full extent of critical success factors, would be a good candidate for commercial funding.

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