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Does Microfinance Fill the Funding Gap for Microentrepreneurs? A Conceptual Analysis of Entrepreneurship Seeding in Impoverished Nations

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Abstract

We address the role microfinance institutions (MFIs) play in funding entrepreneurial ventures and present a distinction between the types of entrepreneurs that seek MFI and traditional venture funding. We argue that microfinance can serve successfully as seed financing for microentrepreneurs in under-developed economies around the world. By comparing bootstrapping and private equity seed-financing in developed economies to microfinance seed-financing in impoverished economies, we show that the different entrepreneurial characteristics in the two economies have similar funding gaps but are solved with different sources of funding.

Keywords: microfinance, funding gap, seed financing

1. Introduction

Entrepreneurs of new ventures often do not have enough of a concept, historical earnings, or assets to justify bank-funding in early stages. This lack of access to capital is commonly referred to as a funding gap for entrepreneurs. In mature economies, this funding gap is often filled from many sources such as cash from friends and family, bootstrapping via credit cards, personal savings accounts, and second mortgages on homes. After the start-up phase, a relatively small percentage of potential high-growth ventures will qualify for investments by private equity (PE) investors, that is, angel groups and venture capitalists. These seed-stage companies in established economies are thus able to draw on the resources of a well-established market and various funding sources to obtain the capital needed for development and growth.

Developing economies, though, often lack sources of seed capital. In particular, microentrepreneurs, those at or near the bottom of the social-economic pyramid, do not have access to bootstrapping methods or private equity. Due to higher poverty levels and lower excess income, entrepreneurs often do not have their own financial capital nor can they readily borrow from impoverished peers and family. The nature of virtually all microenterprises is that they will not have a large harvest or lucrative financial exit, and as such, they do not attract private equity. Such seed capital for entrepreneurs starting companies with little collateral, in a fluctuating and uncertain market, naturally warrants significant risk with very little financial upside.

In these impoverished economies, historically this funding gap for seed financing has been filled by street “loan sharks” who accept the risk of this seed financing but in turn demand extreme profit margins–commonly 100 percent daily rate. For example, a microentrepreneur will borrow $2 in the morning to buy inventory and must repay $4 at night after selling on the street all day. Recognizing that many individuals cannot afford these exorbitant rates and that this situation often perpetuates local poverty, non-governmental organizations (NGOs) such as the Grameen Bank in Bangladesh began to establish an alternative solution to the funding gap in the 1980s – microfinance.

The role of microfinance institutions (MFIs) in recent years has become well known in terms of helping low-income individuals to start small-scale microenterprises and to alleviate themselves from poverty. Microfinance drew particular attention in 2006 when Muhammad Yunus was awarded the Nobel Peace Prize for his work with the Grameen Bank, and in December 2012 there were more than 3,700 MFIs (Microcredit Summit, 2014) which had assets of $70 billion in 2011 (Microrate, 2011), and reached more than 203 million clients (Microcredit Summit, 2014). The literature is fairly well-developed in terms of microfinance governance and best practices, but the impact that micro-financed ventures have in terms of sustainable entrepreneurship (Hulme, 2000) in filling the funding gap has not been widely explored.

In this paper, we provide a conceptual analysis of microfinance and its role in filling the funding gap that exists for bottom-of-the-pyramid entrepreneurs in developing economies. We argue that microfinance (MF) can help solve the funding gap for microentrepreneurs, but it is contingent upon how one defines the objective of an entrepreneur. In developed economies, the entrepreneurial funding gap is typically covered by bootstrapping and (PE) investors as discussed above. These types of investors target specific high-growth ventures that have the ability to provide an extremely lucrative, and large, harvest within five to ten years. In developed nations, equity investors are not interested in investing in a small business which has the goal to simply allow the parents to send their children to school, to put a metal roof on the family home, or to create two or three jobs in a local village. We argue there is a fundamental difference between the mechanism which often fills the funding gap in developed economies (bootstrapping and PE) and in under-developed economies (MF) due mainly to the nature of the entrepreneur seeking the funds and the type of small business (MF) or venture (bootstrap and PE) being created.

The remainder of the paper proceeds as follows. We provide a brief review of the literature as it relates to the funding gap in developed vis-à-vis under-developed economies. We then discuss the reason this funding gap is not filled by traditional financing sources in developing countries, and provide a breakdown of the market and entrepreneurial landscapes that create this funding gap. Next, we provide a conceptual model of the funding gap in these markets, and finally, we discuss ways that innovative groups are seeking to fill this gap.

2. Literature Review and Conceptual Development

2.1 MFIs Service Base-Level Entrepreneurs

In developing countries, there exists a funding gap at the base of the economic pyramid because providing funding to impoverished individuals with little business background and no physical or intellectual business capital often represents too great a risk for financial institutions and equity investors to warrant a substantial return. Khavul, Chavez, and Bruton (2013) report that formal financial institutions such as banks found the poor difficult to serve effectively and profitably, thus leading to an emergence of microfinance institutions to fill this funding gap. MFIs seek to fill this funding gap by focusing on the lowest scale of poverty alleviation and instead seeking to use social capital to help mitigate the risk of default. As discussed in Brau and Woller (2004) social capital is the most important asset many impoverished people have. A good name in the village is extremely valuable to them. Social capital may be defined by combining such terms, as trust, social cohesion, and connectedness. Khavul et al. attribute microfinance's ability to ruse information from social networks in local communities as a way to reduce the monitoring and transaction costs for lenders.

As evidenced by Maslow's (1954) Hierarchy of needs, individuals seek first to satisfy their physiological and fundamental needs before pursuing inner talents, creativity, and desires for achievement and self-actualization. Because of their focus on poverty alleviation, MFIs target individuals at the base of this pyramid who are trying to attain basic needs, enabling them to become self-reliant on this basic level and facilitating their progression up the scale of needs. Eventually, micro-financed entrepreneurs who are able to satisfy their physiological needs will be able to move to satisfying their higher needs for safety, belonging, and self-esteem by moving up the funding curve and continuing to advance in business skills and success.

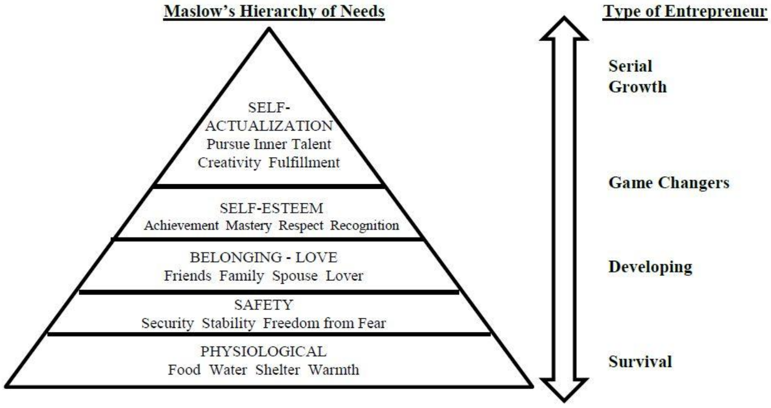

Figure 1. Maslow's hierarchy of needs applied to entrepreneurial type

MFIs help to facilitate this process by providing an initial, small loan amount and then when that is successfully repaid, continuing to provide micro-funding in increasing quantities as the entrepreneur's skills grow and expand. We focus on the funding gap that MFIs fill by enabling entrepreneurs to progress to a point where they can then qualify to obtain traditional financing from a banking institution. However, the literature shows that there exists another funding gap for microentrepreneurs seeking to grow ventures in developing economies into small and medium sized businesses (Rapporteur, 2009; Ody & de Ferranti, 2007; Patricof, 2011).

Because of their target of small-scale, poverty alleviation ventures, MFIs are generally focused on much longer duration (long-term, repeat borrowers are encouraged), simple business, and are not ideally positioned to assist growth ventures to progress with equity risk capital. Lam (2010) addresses the issue of this funding gap, outlining how MFI institutions that seek to fill this role often struggle with profitability and sustainability and entrepreneurs are forced to seek other short-term financial bootstrapping methods.

More recently Khavul and Bruton (2012) address the need for sustainable business models for innovations in clean drinking water systems, cell phones, household electrification, and fuel efficient stoves. They suggest that if viable innovations for Third World nations are to succeed, they need to be designed with local customers, networks, and long-term business systems in mind.

Woller and Woodworth (1999) present a rich discussion of mission creep and the debate between Welfarists and Institutionalists. Welfarists argue that MF should be used at the very bottom of the social pyramid and stay true to its original intent (mission) of serving the poorest of the poor. They argue that MFIs do not need to be self-sustaining to be successful as long as they can raise donor funds in the long-term. Institutionalists on the other hand argue that it is necessary to service the not-so-poor with larger loans so economies of scale can be captured and MFIs can self-sustain. The not-so-poor are typically those barely below and above the poverty line who are often in the position to seek out SME financing to expand growth of an existing small enterprise.

Khavul, Chavez, and Bruton (2013) provide a theoretical model which shows that an institutional change has occurred in microfinance across development logic, market logic, and regulatory logic. Their paper is an illustration of the discussion in Woller and Woodworth (1999) dealing with the institutional organization of MFIs.

3. Theoretical Background and the Proposition

3.1 Why the Funding Gap Exists

The availability of funding sources varies depending on the needs of entrepreneurs in a local area and their access to capital markets. Key to the demand of traditional entrepreneurial funding in mature economies is a ready supply of entrepreneurs who understand the various financing alternatives, can meet the basic funding requirements set in place, and have business models that are suitably matched to the funders' goals.

Developing nations, though, have a distinctly different capital landscape resulting from a less-developed market ecosystem and a fundamentally different base of entrepreneurs. Due to these market limitations and an inherently different supply of entrepreneurs, the funding gap, illustrated in Figure 2 is not filled by the conventional sources found in developed nations as explained below.

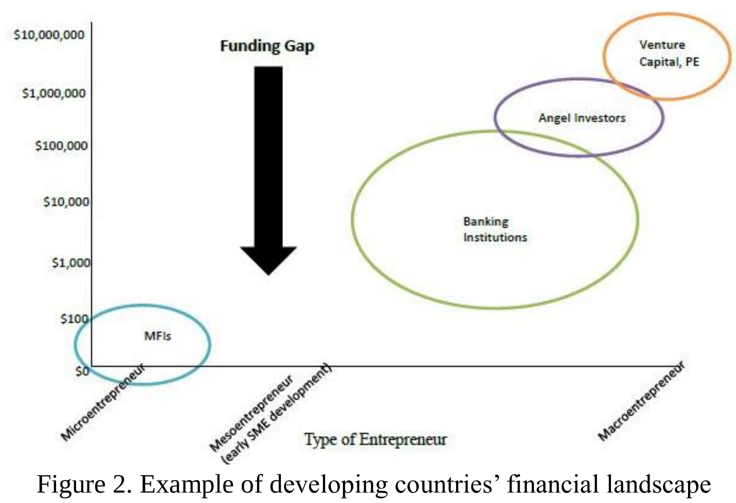

Figure 2. Example of developing countries' financial landscape

3.1.1 Market Limitations

In developed economies, traditional entrepreneurial funding sources (banking, angel investors, PE) rely on the assumption that the market they invest in has certain characteristics that make a return on their investment possible and mitigate inherent risks to a satisfactory level. Financial institutions are interested in providing capital for these companies if they feel the proposed investment is highly viable, the equity portion in the total investment is sufficiently large and in the case of default, assets could be liquidated, and there is some guarantee for the loan (Organization, 2001). In developing countries, the markets are often immature in terms of economic activity and governance, with few exit opportunities and a greater difficulty in profit harvesting. Due to these market limitations, traditional funding sources do not provide the long-term capital needed to grow the business in developing economies.

Informal sources of friends and family capital may also be limited due to market immaturity. De Clercq, Meuleman, and Wright (2010) assert that micro-angel investments (representing informal equity capital received from family, friends, and others) in developing countries will increase as there is increased availability of new business opportunities, more protective legal systems, and the extent that a country's culture and members value the development and maintenance of close relationships with one another. This supports our claim that market maturity plays a significant role in the availability of informal funding sources for entrepreneurs in developing economies.

3.1.2 Market Maturity

An Ernst and Young analysis (Alexander Groh, 2011) identified six key factors that shape a country's venture capital markets and investment attractiveness. These are economic activity, entrepreneurial culture, depth of a capital market, taxation, investor protection and corporate governance, and human and social environment. Ody and de Ferranti (2007) further determine that the challenge of funding growth-oriented SMEs in developing countries stems from the early-stage nature of many ventures and the immaturity of the local economy in terms of stabilization and business conditions. Immature developing economies often lack a supply of partner networks, physical goods, and sufficient interested buyers to continue growing.

Financial institutions rely on regulation and internal and external governance to ensure that the businesses they fund have a fair opportunity to compete in the market environment; there is a fair chance of return of the funding and assets in case of liquidation and legal protection exists against fraud, unlawful seizure of property, and other risks. When favorable regulatory structures are in place, institutions are more likely to invest in microenterprises.

Developing economies sometimes lack the consistent legal structure and regulation needed to mitigate funding risks for external investors. Volatile governments, a risk of nationalization, corruption, and a lack of legislation enabling free enterprise inherently increases the risk of investing in microenterprises.

Internal governance has been shown to have a positive effect on MFI performance. Mersland et al. (2011) study the relationship between firm performance and corporate governance and find that increased competition and bank regulation had little effect on MFI performance when compared with other factors (i.e., increased competition did not result in higher customer benefits although it did result in increased MFI performance; bank regulation had no significant effect on the performance of MFI institutions). In earlier studies it had been found that the more intense the competition, the less owners needed internal governance mechanisms. With Mersland's dataset, nearly 34 percent of the MFIs were regulated by banking authorities.

Ody and de Ferranti also identified high transaction costs and limited deal flow as challenges to investment in SMEs in developing countries. This further deters outside investment in this area of funding and perpetuates the funding gap (Ody & de Ferranti, 2007).

3.1.3 Few Exit Opportunities

In addition, VC firms and many angel investors are focused on an entry, mentoring/monitoring, and exit model. In developing nations where MFIs are prevalent and the funding gap is most prominent, there often is not an established market to facilitate exit opportunities by acquisition or public sale (Sanyal, 2005, Deutsch Bank, 2007, and Patricof & Sunderland, 2005). Due to this potential illiquidity VCs and angels that have sought to enter these developing markets have had to adapt their investment models to accommodate for limited harvest opportunities. Sanz and Lazzaroni's (2009) analysis of Nicaragua's Micro Venture Capital firm, Agora, found that although less than $100,000 in funding was needed for the average start-up company, the developing market tended to have few exit opportunities and entrepreneurs tended to have little personal capital invested in their ventures, resulting in potential dilution of founder ownership share and incentive if equity funding was obtained. To overcome these barriers, Agora adapted its strategy to the Nicaragua's market circumstances, using an alternative dividend exit model, and continued to aim for at least a 25 percent internal rate of return on all its investments.

3.1.4 Profit Orientation

In developed economies, banking institutions provide loans in amounts large enough and at rates high enough to justify the paperwork and due diligence involved with issuing and managing a loan, and to be able to achieve a return satisfactory to its shareholders. This amount is typically larger than the microloans provided by MFIs and although banking institutions could provide the funding necessary to fill the funding gap needed for microentrepreneurs to develop growing ventures, most financial organizations do not obtain enough benefit to justify the risk. In addition, entrepreneurs often cannot get business loans until they have three years of successful books and may have to sign personal collateral to secure the loan. Microentrepreneurs in developing countries lack the history, collateral, and often the business knowledge to successfully obtain these institutional loans.

In the developing world, the market dynamics are not in place for equity investors to obtain a sufficient return. Private equity funders and angel investors want a significantly higher return such as a 10x on their investment. In addition, equity investors need to invest a significant portion of their multi-million dollar funds into a company in order to “move the needle” and make it worth the investment effort. Traditional entrepreneurial financers may also face difficulty in seeking to fill this funding gap. Sanyal (2005) outlines several risks of using venture capital in the MFI industry contrasting the venture capital common method of injecting cash for an equity return expected over a three to ten year duration, with the MFI model that is conventionally debt-based, issuing small, short term loans. Because of the need for financial institutions to obtain a profit return for their shareholders and limited partners, many funders focus on larger deals in developing markets and businesses that demonstrate a commercial return. Ody and de Ferranti found that many commercial investors gravitated to minimum investment sizes leaving smaller SME equity investments unfunded and perpetuating the existence of a funding gap for these SME entrepreneurs (Ody & de Ferranti, 2007).

In a developing economy, with an immature market and few exit opportunities, these high returns are significantly less likely and investment in microentrepreneurs and SMEs represent substantial risk. Since other opportunities in areas around the world are often better suited to the PE model and better able to return a high profit margin, equity investing has not focused on filling the funding gap in developing economies.

MFIs are better able to fill the funding gap in developing economies because of their focus on social impact, such as poverty alleviation, and their satisfaction with lower profit levels. The research shows that profitability does not vary significantly across for-profit and not-for-profit MFIs. Tchakoute-Tchuigoua (2010) finds that performance of private MFIs is better than that of NGOs only when portfolio quality is used as an indicator of performance. In general, non-profit and for-profit MFIs have similar financial success although for-profit MFIs also tend to be more socially efficient than not-for-profit MFIs. It was also found that MFIs are generally financially and economically profitable regardless of legal structure and that the average efficiency of cooperatives is higher than for private microfinance companies and NGOs.

3.1.5 Gestational Period

Typically PE firms set up limited partnerships that last 10 years and then invest in a portfolio of firms. Historically, only one to three firms in a portfolio actually end up being a home run producing a 10x or so on money invested which generates a majority of the returns (Timmons & Spinelli, 2006). The remaining firms return a mediocre return, underperform or die. Of course, this is not the model that many microentrepreneurs desire to follow – they do not hope for the home-run. A microfinanced borrower can run a successful business to support her family for a lifetime. With this lifestyle-return approach, there is no major harvest (no IPO or buyout) and thus there needs to be a very high success rate of repayment rates for MFIs to stay in business. This segmentation is why the funding gap exists.

Table 1. Funding sources chart

Organization	Focus	Resources	Common Initial Investment Size	Target Entrepreneurs
Loan Sharks	Highest return possible	Capital	$1-$500+	Lowest level of the pyramid
MFIs	Poverty alleviation	Other aid organizations	$1-$500	Poverty stricken, often women, small-scale businesses
Banks	Secured return, mitigated risks (historical)	Local connections, follow-on funding	$2,500-$50,000	Business competency, low morale hazard and adverse selection, high ability to repay
Angels	Higher return, strategic investment	Mentoring, relationships, access to additional funding sources	$50k-$2M	Synergistic management team
VCs	10x return, high growth business, large market opportunity, exit	Longer Gestation Periods, Network, Mentoring, Operational Acumen, greater risk sharing	$1M-$10M	Strong management team with skills, experience, and ability to grow company; innovative, high business competency

Table 1 illustrates the various funding sources for entrepreneurs in under-developed and developed economies. The type of investor ranges from loan sharks and MFIs to angels and VCs. As can be seen in the figure, the focus, resources, investment sizes, and target entrepreneurs vary significantly between organizations.

3.2 Type of Entrepreneur

MFIs focus on funding the needs of a fundamentally different type of entrepreneur than is typically targeted by banking institutions, angels, and venture capital firms. In developed economies, entrepreneurs tend to have a base level of physical and financial capital, and a base level of business knowledge or the resources to obtain these quickly. In developing economies, there is a gap in the knowledge and resources available to microentrepreneurs. MFIs focus on individuals at the base of the pyramid in developing economies that may lack all of these assets and have little experience to enable them to start a successful business at all. MFIs tend to invest in these types of entrepreneurs for reasons other than just financial return, including for the economic well-being and poverty alleviation of the clients themselves, but this does lead to a different approach in the creation of new ventures than is typically seen in mature economies. Several distinct differences between entrepreneurs in developing vis- à-vis developed nations follow.

3.2.1 Experience Level (Knowledge Gap)

There are many challenges that exist in seeking to fill the funding gap in developing markets. These include educating individuals about the difference between charity, lifestyle businesses, and commercial growth opportunities. . Developing countries often have raw entrepreneurial talent (Patricof & Sunderland, 2005) with little past technical and business experience. Developing and scaling a new enterprise takes significant effort and many investors cite management as the number one factor in a new venture's success. Betaieb, Arab Academy of Technology Transfer, cited weak management practices and not understanding the importance of networks as contributing factors to the funding gap in developing countries (Rapporteur, 2009). Microentrepreneurs in immature markets often lack the money and skills necessary to grow their businesses to a level beyond a single person venture or a business with only a few employees. Bateman (2010) addressed the issue by questioning whether it is a misuse of a country's labor force to let people operate in an informal sector with low productivity as opposed to using this labor force to develop higher impact, sustainable growth opportunities (Mersland & Strom, 2009).

Some MFIs seek to overcome this knowledge gap by teaching entrepreneurship and business skills, but microfinance resources are stretched to be able to provide the type of mentoring needed beyond starting a small-scale microenterprise and there are few resources in the community to obtain this additional direction. Mentors International is a case wherein training clients yielded positive success rates compared to other MFIs which did not offer entrepreneurial education to loan recipients (Brau, Hiatt, & Woodworth, 2009 and Exchange).

3.2.2 Weak Culture of Entrepreneurship (Resource Gap)

Developing economies often have a weak culture of entrepreneurship due to lack of role models, opportunity, and a general feeling of hopelessness (Harrison & Huntington, 2000; McClelland, 1987). This is seen in part by the tendency for microentrepreneurs to cannibalize each other's markets instead of responding to the competitive landscape and differentiating product offerings. In a 2009 Global Forum on Innovation and Entrepreneurship, Lebendiker cited that in Central America, 90 percent of the subsistence enterprise resulting from microfinancing involves women replicating a similar idea, i.e., cannibalizing each other's sales and growth (Rapporteur, 2009). This market saturation was also seen by Mentors International, an NGO in the Philippines founded by one of the coauthors. An individual would use MFI funds to start a small venture and soon another client, seeing the first person's success, would establish a similar business in the same area, then often another borrower would do the same. Such practices resulted in dilution of the overall profits of the three microentrepreneurs. It often took a year or more before Mentors International succeeded in convincing most of these clients to spread out to other areas and new markets.

Entrepreneurs in mature economies, in contrast, tend to have a greater understanding of market dynamics and benefit from a culture that is more oriented towards entrepreneurship. Mature economies welcome new ventures and entrepreneurs, and readily provide educational, capital, and mentoring resources to facilitate the growth of new ventures. Formal and informal networks tend to be more established in developed economies, enabling entrepreneurs to quickly gain access to resources and respond quickly to market changes.

A weak culture and understanding of entrepreneurship also leads many individuals to use microfinance for resources other than business creation. In his research, Lensink (2011) reports various contributions from the World Development Seminar, and finds that lending technology and type of contract used have significant consequences on the way borrowers use the loans. Loan contracts with regular repayments may discourage borrowers to invest in projects requiring longer gestations, group lending systems may also lead to short-term returns. The poor use financial services not just for business investment, but to invest in health, education, household emergencies, and cash needs.

Lensink compares the goals, target population, and the management principles under a banking logic paradigm, a development logic paradigm and an emerging commercial microfinance logic paradigm. These observations provide evidence of the difference in the funding gap for developed versus under-developed nations. For each of these conventional funding sources, there is an expectation by the funder for a significant return and benefit. In return, many of these funding sources provide the entrepreneur with more than just financial capital. In developed economies, bootstrapping and commercial loans enables entrepreneurs to retain equity and ownership of the company, angel investors often provide mentorship and direction for companies, helping them to begin to establish relationships with key partners, venture capital firms provide networks, access to additional funding and potential exit opportunities. This so called "smart money" is what helps entrepreneurs to grow and develop their businesses into successful companies.

In traditional entrepreneurial financing, such as venture capital, firms often benefit from strategic synergies and insights from the investors in addition to obtaining financial capital according to Arping and Falconieri (2010). In the same sense that PE in developed economies offer more than just financial support, to promote sustainable, growing ventures in developing countries, MFIs frequently provide a certain degree of mentorship, skills, and training for new startups.

4. Conceptual Model

We present the following model as a comprehensive explanation of the funding gap in developing countries and how MFIs are filling this gap. As illustrated in Figure 3, microentrepreneurs make up the largest market size in terms of potential venture creation in developing economies, and in addition to the funding gap discussed previously, these entrepreneurs face a significant resource and knowledge gap. MFIs seek to fill this funding gap in developing economies by focusing their efforts on the base of the pyramid and providing more resources than just access to financial capital. As illustrated by the inverted pyramid, MFIs provide the smallest funding size, even essentially down to a dollar or two. The conventional banking system and small amounts of angel and equity investing fill the remaining demand for funding needed for SMEs and high growth companies and can include substantially larger amounts of capital.

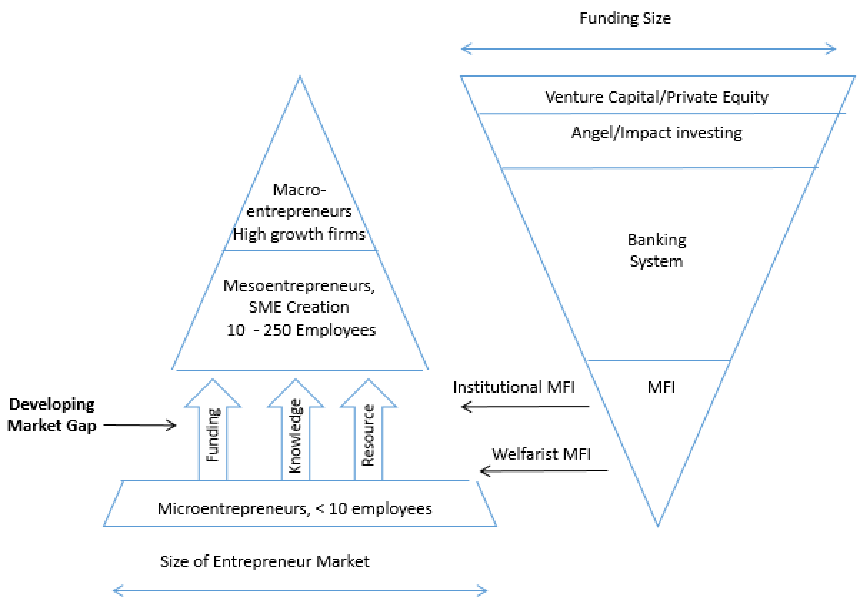

Figure 3. Funding and entrepreneur landscape in developing markets

As described in the previous section, in addition to minimal funding opportunities, microentrepreneurs often lack the knowledge and resources necessary to grow and expand their businesses. Traditional forms of entrepreneurial financing (i.e. banks and equity investors) assume a base level of knowledge for the entrepreneurs they invest in and provide additional resources such as networking, mentoring, partnership opportunities, and additional access to capital. Microentrepreneurs present too great a risk for many financial institutions to invest the time and effort needed to provide a sufficient return (Brau, Merrill, & Staking, 2011). Thus the knowledge and resource gaps perpetuate the problem of the funding gap.

By focusing on the strategic goal of alleviating clients from poverty, MFIs often provide additional assets of knowledge and networking to loan borrowers to enable them to understand basic business skills and financing terms, gain access to markets wherein they can build their business successfully, acquire additional skills and resources to promote their personal education and the education of their children, and improve their standard of living.

Woller and Woodworth (1999) describe a further distinction in the focus of MFIs in filling this funding gap. Institutional investors, such as the World Bank and USAID focus on creating a sustainable financial intermediation for the poor, and the MFI market here is dominated by numerous for-profit institutions that assist impoverished individuals while seeking to avoid subsidies and assistance to maintain operations. This is contrasted by the Welfarist MFI which tends to focus on self-employment for the poorest of the poor even if some of these services require subsidies. Examples of this type of MFI include the Grameen Bank and FINCA-style (The Foundation for International Community Assistance) village banking methods.

For example, the FINCA model of Village Banking tends to emphasize reaching to serve the “poorest of the poor” which often means sending staff to recruit in the most impoverished area of a town. Often located in rural settings, this requires travel costs like motorcycles and gasoline, as well as compensation expenses for staff travel. These recruiters may have to include not only simple business skills such as accounting, sales techniques, and so on, but literacy and basic math education so that upon receiving a microloan, clients will be able to read financial statements, make bank deposits, and draft business reports. Designing educational materials, conducting pilot tests of effectiveness, printing and delivering such products, all become quite expensive, especially for small MFIs. So for FINCA and other Welfarist MFIs, a special fund is established by the organization for covering such expenses which are above and beyond simply servicing their loans (Hatch, 1999).

While Welfarist MFIs facilitate poverty alleviation at the lowest section of the pyramid, many of the ventures invested in do not grow significantly to provide income to a large number of households. Institutional investors, in contrast, can play a significant role in helping microentrepreneurs scale their ventures up to a level where they can then qualify for bank financing. The research is sparse in terms of the long-term, economic development impact microfinanced firms have on the local market but we assume herein that microfinanced ventures that scale to an institutionally financed stage can continue to scale and achieve significant growth making a high impact on the developing country's economy.

5. Case Example

A case illustrating the difficult gap between the amount of available microfinance capital and the demands of entrepreneurial start-ups is that of FINCA International. Launched in Bolivia by a former Peace Corps activist, John Hatch, in the early 1980s, a type of solidarity group model was created which he called Village Banking. In this methodology, a FINCA loan officer would go to a village, explain the concept, and ask village elders to choose 50 poor women who could use a $50 loan to start or expand a business. But the funds for FINCA's program were limited. Banks and venture capitalists thought the idea of loaning tiny amounts of capital to the poorest people in a community was preposterous. So this new NGO, FINCA, was dependent on obtaining small donations from average Americans with which to operate in impoverished Latin American areas where no one had capital, and where generations back through history were stuck in an economic caste system with no way out. The poor lacked confidence that they could dig themselves out of poverty. The banks and governments in those countries distrusted such individuals, and furthermore, the capital amounts needed were too small to use for making individual microloans, because lenders could not make decent returns on such tiny loans.

Over time FINCA staffers were trained and mobilized to actively seek borrowers. It worked as follows: A contract was signed with the village elders, some 50 loans were issued for four-month terms to very poor women, and the women would jointly guarantee all of the loans. Four months later, the loan officer would return, collect the payments of principal and interest, and issue new loans for the original amounts plus any savings that the women set aside. Thus, FINCA used monies saved by poor clients to bootstrap the growth of microenterprise start-ups and eventual success.

FINCA operated a number of such programs over the next few years, while Hatch gave traveling workshops in which he taught the Village Banking model and methodology to numerous emerging microfinance institutions. The model was implemented, in those early years, mostly in Latin American nations.

After a few years of slow expansion and experimentation, in 1989 FINCA convinced the United States Agency for International Development (USAID) to award the organization a $10 million grant to expand its El Salvador operations. Over the next three years, from 1990 to 1993, FINCA opened over a thousand village banks in both urban and rural areas of El Salvador, making it perhaps the largest program in Latin America. Its funds seemed enormous back in the day, but it was, in fact, extremely small when compared with the need for grassroots capital for Salvadoran have-nots. On the other hand, of course, it was the largest commitment of microfinance funds by USAID or any other government agency up until that time period.

FINCA thus became a facilitator within the microfinance movement, and following USAID's lead, other large development institutions began to provide funding as well, including the Overseas Private Investment Corporation (OPIC), the World Bank, Oxfam, the Inter-American Development Bank (IDB), United Nations, the Consultative Group to Assist the Poor (CGAP), the International Labor Organization (ILO), the Islamic Development Bank, the International Finance Corporation (IFC), and many more such organizations. Gradually, foundations such as the Omidyar Foundation, the Bill & Melinda Gates Foundation, the Ford Foundation, and so forth began to offer funding.

Finally, the radical idea of micro-lending to the poor has been increasingly embraced by the formal finance sector including Deutsche Bank, Citi, Mastercard, Wells Fargo, Goldman Sachs, and the European Bank for Reconstruction and Development (EBRD).

FINCA was clearly a successful pioneer in refuting the assumption that poor people are not credit worthy, and that microfinance could serve as one solution for the microentrepreneurial funding gap. The microfinance movement, while able to fill some of the funding gap, is still plagued by the challenge of raising sufficient capital to meet the potential for entrepreneurial growth.

6. Future Research: Role of Alternative Funding Solutions

Some organizations have recognized that there yet remains a funding gap between MFIs and traditional financing and are seeking to fill this gap through innovative hybrid models. In addition, the blurring of boundaries is increasing the availability of MFI and alternative funding and resulting in an increase in entrepreneurial investment for local communities. Some VCs are beginning to move into the MFI industry, but it is primarily with social venture efforts for possible fixed income-like returns. When PE operates in the MFI space, it is typically investing in MFIs, and not investing in actual microentrepreneurs directly.

For example, a Congressional subcommittee report cited several examples of MFI's focusing on technology start-ups. Mecene Investment has a $13M fund dedicated to equity investments in sub-Saharan Africa. It invested $1.6M in a Kenyan MFI, and the company went public three years later in 2006 and became the largest microfinance bank in Kenya with a $700M market cap in 2009 (Trade, 2010).

When Unitus was founded in 2000 by one of the authors as the world's first "microfinance accelerator," it initially depended on wealthy donors from whom it secured some $10 million in the first four years, funds which would then be loaned or simply donated to empower relatively new, small MFIs to grow more rapidly from an average of just several thousand borrowers to 40,000-80,000 borrowers. This worked well for a time because of Unitus' deeply committed donors who became excited about the prospects of doing good with some of their resources and fighting poverty through this relatively new strategy of financing the "poorest of the poor."

However, eventually Unitus' board recognized it would need significantly greater amounts of capital to dramatically expand beyond initial partners and also have new monies to begin supporting other small NGO startups. In 2004, Unitus began to see the opportunities for commercialization of microfinance in India, an underserved market for microcredit at the time. It created a separate investment fund in 2005 called Unitus Equity Fund (UEF), a first-of-its-kind, early-stage catalytic microfinance equity fund. This enabled it to connect with more wealthy individuals who were willing to invest with the fund, rather than simply making a donation. Their commitment and philosophy was that of becoming social-impact investors who would give Unitus millions for a time, but eventually wanted not only their principal back, but a small return. Usually such amounts were in the range of $2-3 million for a period of several years.

Over time, UEF built a portfolio of some $20 million which allowed it to significantly invest in six MFI partners, five in India where the MFI market was expanding rapidly, and one in Mexico. By utilizing an equity approach, Unitus could take a minority stake in these microfinance organizations, aiding their quest to develop high-quality financial products while providing a small, but reasonable return to UEF investors. Fundraising for the micro-equity fund was challenging because of the risks involved in venture investing in small, private, overseas microfinance institutions in foreign currency with little visibility for liquidity. Thus, these investors needed to understand that they were putting their capital at risk for the potential of significant social benefit primarily, not financial gains alone. This distinction is significant in that it shows that the UEF investing was not PE investing in the same sense as in developed nations. There would be no large harvest after a relatively short venture launch.

Along with UEF's approach to generating more capital for MFIs, several of the Unitus board developed another equity fund for fostering microfinance growth. It became known as the Dignity Fund, and has been doing similar work securing new money to facilitate new, small microfinance NGOs that Unitus, for various reasons, did not offer monies. So far it has invested in 14 MFIs in 12 nations, and had a profit every year of its existence. These profits are not in line with the profits expected by angels and VCs in developed countries. Dignity is mainly concerned about funding MFIs to offer microcredit to fund microenterprises.

In some areas of the world, the funding gap is also being filled by informal friends and family network. Lam (2010) highlights the Chinese informal funding method of Hui, where individuals each put money into a pot and at the end of a period members will bid on the ability to use the money, with the winner generally being the person who is willing to pay the highest interest rate. Lam argues that financial bootstrapping and informal funding resources were more important than even debt and equity.

As reported in the *Times of India*, from 2008 to 2009, of the 50 private equity deals worth $1B in banking and finance in India, investments in MFIs totaled $200M and accounted for 20 of the deals (Ramalingam 2009, Aug 1).

Pretes (2002) performed research on the potential for equity-based MFIs in low income countries. Using the Village Enterprise Fund in East Africa as an example, he argued that startup grants and equity financing are beneficial for low-income entrepreneurs in addition to the contemporary MFI debt.

In developed countries many institutions are beginning to reach out to fill the funding gap between MFIs and traditional funding sources. Many mature economies (such as the United States) are beginning to offer microloans to businesses to start, from $500-$50,000. These loans are provided by groups such as the Small Business Administration, Accion USA, Kiva, Communities at Work Fund, Association for Enterprise Opportunity, and Microfinance Gateway. (Administration, 2012). Many of these organizations administer their loans using traditional American, individual-focused lending practices, not the group methods of Grameen Bank or FINCA.

7. Conclusion

In this article we have provided a conceptual discussion of how microfinance can provide seed capital to fill the funding gap experienced by microentrepreneurs in developing economies. We contrasted seed financing in developed economies which consists primarily of bootstrapping and private equity investors. We argued that these same types of seed capital are not available to the poor across the world who live day to day, commonly on less than $2 per day. Microfinance has the ability to serve as seed capital for the poor because the nature of the microentrepreneur is significantly different than the developed-world entrepreneur. In the developed world, bootstrapping and private equity typically have the end-goal of a large financial harvest such as an IPO or a sell-out. These types of large cash-outs do not exist at the bottom of the social pyramid. Microentrepreneurs use the seed capital of microfinance to run simple businesses for a lifetime designed to feed the family, allow children to go to school, and to provide adequate housing.

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