



# Overcoming Barriers to Scale: Institutional impact investments in low-income and developing countries

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Written by Gabriel A. Huppé and Mariana H. Silva

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## Table of Contents

Executive Summary .....	1
1.0 Introduction .....	5
1.1 What is Impact Investing? .....	5
1.2 Where Are Impact Investments Made? .....	9
1.3 What is the Process for Investors’ Asset Allocation and Investment Selection? .....	10
2.0 The Problem with Impact Investing.....	13
2.1 Shortage of Attractive Impact Investment Deals .....	14
2.2 Investment Track Records .....	15
2.3 Blended Capital Curve .....	16
2.4 Scalability .....	16
2.5 Sourcing Deals/Investment Costs .....	18
2.6 Impact Measurement .....	19
2.7 Exit Options .....	19
3.0 What Governments Can Do .....	21
3.1 Plumbing and Housekeeping.....	21
3.2 Impact Investment Policies.....	24
3.3 The Entrepreneurship, Inclusive Economy, Investment and Development Nexus .....	29
4.0 Innovative Financing for Impact Investing: Enabling Blended Capital Structures.....	31
4.1 Applying Securitization to Allow Blended Capital Financing Structures .....	32
4.2 Alternative Funds .....	35
4.3 Social Impact Bonds .....	36
5.0 Building the Impact Investment Ecosystem: Best Practices in Implementing Enterprise-Based Development in India .....	38
5.1 India Context and Government Initiatives.....	39
5.2 Aavishkaar Group of Funds.....	41
5.3 Intellegrow: Impact Investment Venture Debt Model.....	44
5.4 Intellegap Impact Investment Network (I3N): Impact Angel Investment Network .....	46
5.5 Interplay, the Investment Pipeline and Institutional Investors: A Systems View of Impact Investment Initiatives in India .....	48
6.0 Conclusion.....	51
References.....	54

## Glossary

**Asset class:** A group of securities that exhibit similar characteristics, behave similarly in the marketplace and are subject to the same laws and regulations. The three main (but not only) asset classes are: equities (stocks), fixed-income (bonds) and cash equivalents (money market instruments). Others include real state, forex and commodities.

**Financial instrument/security:** A financial instrument that represents: (i) an ownership position in a publicly traded corporation (stock), (ii) a creditor relationship with governmental body or a corporation (bond) or (iii) rights to ownership as represented by an option. A security is a fungible, negotiable financial instrument that represents some type of financial value.

**Financial-first investors:** Investors seek to optimize financial returns with a floor for social/environmental impact. This group tends to consist of commercial investors who search for subsectors that offer market rates of return while yielding some social/environmental good. These investors may be driven by fiduciary duties, as in the case of pension funds.

**Impact-first investors:** Investors seek to optimize social or environmental returns with a financial floor. This group uses social/environmental good as a primary objective and may accept a range of returns, from principal to market rate. This group is able to take a lower-than-market rate of return in order to seed new investment funds that may be perceived as higher risk, or to reach tougher social/ environmental goals that cannot be achieved in combination with market rates of return.

**Investment vehicle:** A product used by investors with the intention of having positive returns; any method by which individuals or businesses can invest and, ideally, grow their money. There is a wide variety of investment vehicles that are not necessarily financial instruments. This term covers all investments, from art and coins to complex credit default obligations (CDOs).

**Social impact:** The effect of an activity on the social fabric of the community and well-being of the individuals and families.

**Structured finance products:** Products that combine traditional asset classes with contingent claims, such as risk transfer derivatives and/or derivative claims on commodities, currencies or receivables from other reference assets.

## Executive Summary

Upon reviewing recent reports on impact investing by various organizations, the authors noted that there is conceptual appeal for large institutional investors to participate in the impact market. However, due to unresolved barriers, large investors such as pension and sovereign wealth funds are unable to participate in this attractive investment thesis of the asset class.

Based on an analysis of the seven key problems facing institutional investors wishing to participate in impact investing, we provide a series of recommendations for key industry players and public policy-makers. We propose a focus on financial instruments, host regulatory mechanisms and policy initiatives. In particular, we suggest that innovations in financial instruments and fund structures may help resolve the primary challenges faced by pension and sovereign wealth funds, while government support can help reduce the barriers related to secondary problems. We also discuss an ecosystem approach to impact investing and entrepreneurial activity and apply this framework to the Indian ecosystem.

We integrate our various findings and propositions into a framework to evaluate National Impact Investment Readiness (NIIR), which can be used by both the financial industry and policy-makers in low-income and developing countries. The financial industry can use this framework to assess the “investability” of emerging impact investment markets in terms of making an impact in these countries, all while achieving returns that are in line with their fiduciary obligations. The National Impact Investment Readiness Assessment (NIIRA) can thus help investors prioritize impact investment markets and sectors at the country level. Policy-makers in countries with a national agenda to promote impact entrepreneurialism and enterprise-based development can also use the tool.

Readers already familiar with impact investing and institutional investor concepts can skip over Section 1 of this report, as it is the context-setting discussion of the impact investment landscape for the sections that follow. Section 2 of this report is the product of a comprehensive review of this landscape and recent activities by prominent impact investors. In it, we discuss the seven key problems faced by institutional investors when making asset allocation and investment selection assessments regarding the impact sector. Table ES1 lists the key problems that need to be overcome to unlock greater institutional capital into the impact investment space.

**TABLE ES1: KEY PROBLEMS FACED BY INSTITUTIONAL INVESTORS WANTING TO ENTER THE IMPACT INVESTMENT SECTOR**

PRIMARY PROBLEMS	SECONDARY PROBLEMS
Investment risk/ return profiles	Impact measurement
Investment track records	Blended capital curve
Exit options	Scalability
	Sourcing deals/investment costs

Source: IISD

The following two sections discuss the government initiatives (Section 3) and innovative financing options (Section 4) needed to address these key problems. Government initiatives include the policies and programs designed to ameliorate the general investment/business environment and policies and programs targeted specifically at the impact investing and entrepreneurship sector, as listed below. We discuss these initiatives from the viewpoint of governments wanting to promote an enterprise-based approach to development.

- **Strengthening the pipeline:** Various mechanisms are available to governments in building a stronger pipeline of investment-ready ventures. These include technical assistance programs, early-stage funding programs, entrepreneurship development, networking, the promotion of successful business models, partnerships with capable organizations and creating linkages between the global and local impact investment community.
- **Promoting and enabling blended capital arrangements:** Whereas institutional investors are primarily interested in maximizing investment return for a given level of impact, impact-first investors like foundations and development finance institutions are interested in maximizing impact for a given level of investment performance or capital preservation. Various blended capital models can be supported by governments to appeal to these various types of investors.
- **Tax policies and subsidies:** Policies giving preferred tax treatments and subsidies to impact sectors of interest can have an important influence.
- **Data and impact reporting:** Sufficient quantity and quality of data is a pervasive problem in the impact investment market, and is preventing institutional investors from making informed decisions.
- **General business and investment environment:** As with all investments in low-income and developing countries, the political and macroeconomic context has a strong influence on financial performance.
- **Consider the fit of local pension and sovereign wealth fund mandates with national impact objectives:** There exist several examples of institutional investments being used to serve beneficiaries and their communities in social, environmental and economic terms, all while achieving reasonable financial returns. The use of economically targeted investing by pension funds in the United States and the use of the Mubdala Fund to finance the development of Masdar City in Abu Dhabi are some examples.

Innovative financing options are needed in order to enable blended capital arrangements. We discuss some of the most prominent examples, which are listed below.

- **Securitization:** Securitization is the process of taking several illiquid assets and, through financial engineering, transforming them into a security that will be backed by these assets (typically loans). The key advantage of these asset-backed securities is that they divide their risk into different “tranches” or layers. Each layer represents a different level of risk: (i) senior—the least risky; mezzanine—medium risk; and junior—the riskiest. These layers mean that a variety of investors with different risk tolerance can buy the asset-backed security that is most suitably aligned with their risk tolerance and fiduciary duties.
- **Alternative fund structures:** These alternative funds are similar to securitization in the sense that they achieve an effective risk allocation: the first revenue stream entering to the fund is allocated to the senior equity holder and the last revenue streams are allocated to the lowest tranches of the equity. This method of layering the capital creates a way of structuring the fund in various investment tranches that appeal to different parties.

Finally, none of the government initiatives and innovative financing options is sufficient in themselves for generating a robust and reliable pipeline of profitable investment-ready enterprises. To fully exploit the potential of government initiatives and innovative financing in building and expanding this pipeline, it necessary to employ an ecosystem approach to assessing impact entrepreneurialism at the country level. The value of this ecosystem approach is in the linkages that it makes between the government and financial industry activities and in identifying the areas that may be lacking and thus causing barriers to the full scaling of the impact sector. Therefore, we applied an ecosystem

lens to the activities of pioneering firms (Aavishkaar Group of Funds, Intellegrow Finance, Intellecap Impact Investing Network) and government initiatives in India, allowing us to demonstrate the collective impact of these individual efforts. Furthermore, we identify several knowledge gaps facing institutional investors and the need for greater support of national impact investment readiness, staged investing and capital stacking throughout the Indian ecosystem. Current barriers are:

- Institutional investors lack an understanding about the emerging market-specific risks and the actual business-model risks (different from perceived risks) underlying impact investments in these countries.
- More research needs to flow to investors to meet their specific needs.
- Because of the nascence of the impact investment sector, there is a need to further define the field of impact investment in low-income and developing countries, and a need for reliable ratings for making transparent and accurate assessments of the real impact of enterprises.
- Institutional investors' participation in local networks and dedicated impact investment forums in countries of interest can help lower some of their knowledge barriers.
- Complementary impact investment products and services may best be provided through a highly networked model that enables various synergies between market players (in this case, the players considered are Aavishkaar Group of Funds, Intellegrow Finance, Intellecap Impact Investing Network and the government).
- Institutional investors play a crucial role in impact investment and entrepreneurial ecosystems by providing the needed capital for the consolidation stage of an enterprise, thus buying out the companies and providing an exit for early-stage investors.
- Government support is also highly critical, as illustrated by the noticeable influences of early national policy support for the impact sector dating back 30–40 years in India.

The insights discussed in sections two (what governments can do to address the key barriers to institutional impact investing in low-income and developing countries) and three (what financial innovations are needed to enable blended capital investment arrangements) are not novel in themselves, are covered somewhat superficially and are largely based on current wisdom in the impact investment industry. However, the integration of these insights into an ecosystem approach to evaluating the effectiveness of impact investment initiatives across government and financial industry activities is more novel. Following our comprehensive assessment of institutional impact investing in low-income and developing countries, we believe that the single most important concept for unlocking larger sums of institutional capital directed at the impact sector in these countries is NIIR. Furthermore, we have found that various sub-components of this concept are already being used by institutional investors when assessing how much capital to allocate to the impact sector in low-income and developing countries, and the selection of sectors, markets and individual enterprises for investment. Therefore, as a product of our analysis, we propose NIIRA as a new tool for national policy-makers and institutional investors.

Composed of five main assessment areas, as depicted in the framework below, the main objective of the tool is to allow investors and policy-makers to assess the quality, strength and size of a country's impact investment pipeline. A top tier pipeline will consistently and reliably generate profitable and scalable impact enterprises into the future. National public policy-makers can use this assessment framework to identify the areas that are lacking or that are hampering the scaling of the impact sector in their country. Institutional investors can use the tool on a global level to prioritize impact investment markets. The IISD will further develop the concept and the NIIRA tool for this purpose.

**TABLE ES2: NATIONAL IMPACT INVESTMENT READINESS ASSESSMENT FRAMEWORK**

<p><b>1. National political and economic context</b> (e.g., housekeeping factors such as macro policies, political economy, local financial markets, corporate governance standards; plumbing factors like legal and regulatory frameworks, custody, clearing and settlement and taxes)</p>	<p><b>2. Impact investment policies</b> (e.g., financial, economic, regulatory, technological, skills and information, relevant infrastructure, institutions and networks)</p>	<p><b>3. Financial industry initiatives</b> (e.g., availability of innovative financing, financial player's programs for enhancing competitiveness in the impact sector; extent to which complementary resources and services are coupled with funding programs)</p>
<p><b>4. Ecosystem completeness</b> (e.g., interaction of the parts and interlinkages between ecosystem scales; size of impact investment opportunity set and projected size and robustness of the impact investment pipeline into the future; investment readiness of these enterprises)</p>		
<p><b>5. Global fitness</b> (e.g., national entrepreneurialism orientation, impact data measurement and reporting, relations to global investor networks)</p>		

The audience for this report is varied. Seasoned impact investing professionals would be advised to skim over sections one (Introduction), three (What Governments Can Do) and four (Innovative Financing for Impact Investing), as the material covered in these sections are nothing new and simply the product of a comprehensive review. These individuals, however, would benefit from reading our assessment of the seven key problems facing institutional investors as discussed in Section 2, our integrative ecosystem assessment of government and financial industry initiatives in India (Section 5) and our concluding thoughts with regards to the NIIRA tool in Section 6. Uninitiated readers or those with a more basic understanding of impact investing and institutional investors would benefit from reading the whole report, as it provides a succinct discussion of some of the most current issues.



## 1.0 Introduction

### 1.1 What is Impact Investing?

As an investment intended to create positive impact beyond financial returns, impact investing is seen as an appropriate and economically effective way to complement government procurement and philanthropy in solving the world's greatest problems at scale. Initially the purview of foundations, impact investing has become a viable asset class for a large variety of investors, ranging from wealthy individuals to pension and sovereign wealth funds. The term itself is a relatively recent one and can be traced back to the efforts of the Rockefeller Foundation. In 2007 and 2008 the Rockefeller Foundation held meetings with leaders in finance, philanthropy and development in its Bellagio Centre in Italy to explore how a global industry for investing in social and environmental impact could be built. It is at the 2007 meeting that the term "impact investing" was coined.

At the following year's meeting, the foundation's Board of Trustees approved USD\$38 million to implement the industry-building plans developed at the Bellagio convening. The subsequent years saw the impact investment industry take off, with new investment funds and organizations created specifically to appeal to the impact investment clientele. The Global Impact Investment Network (GIIN) is one organization whose early involvement in the space was instrumental in further developing the concept as well as useful impact investment tools that investors could use to implement these strategies. However, some investment strategies, such as triple-bottom-line investing, microfinance, economically targeted investing (ETI) and blended-value investing were already well established before the advent of "impact investing." And with investors' relatively recent focus on "impact investing," all of these latter strategies have fallen under the umbrella of the impact investment industry.

Although impact investment, as an asset class, is perceived as still being in its infancy, some studies have estimated that the amount of capital allocated to impact investment could grow to USD\$500 billion within five to ten years, which would represent 1 per cent of global assets under management (Monitor Institute). A 2010 survey by J.P. Morgan projected a market-size profit potential between USD\$183 billion to \$667 billion, and invested capital between \$400 billion and \$1 trillion over the following 10 years (J.P. Morgan, 2010). A recent J.P. Morgan survey of 99 of the world's largest impact investors reports a commitment of USD\$8 billion to impact investment in 2012, and reports that these investors were planning to invest an additional USD\$9 billion in 2013 (J.P. Morgan, 2013; GIIN, 2011). Therefore, it is not surprising that many governments around the world, in both developed and developing countries, have begun promoting impact enterprises as a viable, cost-effective way to deliver public goods and services, all while trying to attract private capital to priority sectors and enterprises that can contribute to national "impact" objectives in terms of generating social, environmental and economic outcomes while producing a profit.

**BOX 1: RELATED DEFINITIONS**

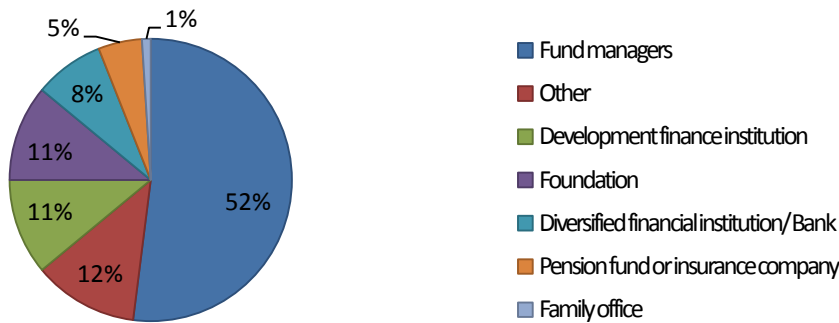
At its roots, impact investing borrows from several related concepts, many of which have served as a foundation for the creation of the industry and the evolution of its theory and practice. Such concepts include bottom-of-the-pyramid (BoP), economically targeted investing (ETI) and triple bottom line, all of which had been developed and practiced prior to the industry's emergence.

1. BoP investing: BoP strategies aim at serving the largest, but poorest socioeconomic group (4 billion people are estimated to live on less than USD\$2.50 per day) while making an economic profit. Companies that target this demographic typically develop innovative business models or products to serve the needs of this population, which has historically been overlooked by the private sector. In doing so, the livelihoods of poor people may be improved via the introduction of products and services that promote better access to capital, more affordable sanitation and health options and technologies that enhance their ability to generate entrepreneurial income. Investing at the BoP proposes to generate social and environmental impact while making a profit.
2. Economically targeted investing: This investment approach consists of targeting assets in order to address unwanted capital gaps and generate socially desirable benefits as well as competitive financial returns. It has been particularly popular in the United States where union-sponsored funds are used to expand employment opportunities in a particular geographical region, increase the availability of affordable housing, strengthen capital infrastructure, revitalize urban neighborhoods, help rural economies, develop SMEs or support green industries. Internationally, ETI supports the mobilization of government resources and domestic savings to promote sustainable development, poverty reduction and core labour standards.
3. Triple-bottom-line investing: The concept argues that companies should prepare three different bottom lines: one is the traditional profit and loss account, the second is the people account, which measures the social responsibility of the organization throughout its operations, and the third is the planet account, which measures how environmentally responsible the company has been. The triple bottom line aims to measure the financial, social and environmental performance of companies through a period of time and acknowledges that the company's responsibility lies with these stakeholders (social, environmental and economic), rather than a singular focus on financial returns.

The following graph depicts the representation of respondents from a recent J.P. Morgan survey (J.P. Morgan, 2013). Of note, fund managers represent the majority of impact investors. Their large representation is indicative of the fact that most impact investments are made indirectly by way of intermediaries, like external fund managers, that have specialized expertise in the impact investment sector. However, as the industry matures, it is likely that many institutional investors will further develop their in-house expertise and seek to manage these funds through direct investments.

Impact investments are currently being made through a very small set of instruments. Although impact investments can be made via a variety of instrument types, the majority of funds invested in impact investments today are either in the form of private debt (52 per cent) or private equity (38 per cent) according to a survey by J.P. Morgan (2011) which collected data on 2,200 impact investment transactions from 57 investors (Table 1). Within debt investments, the majority of investments reported were senior unsecured investments, while 35 per cent were senior secured debt. Within equity investments, 94 per cent represented minority stakes in the investee fund or company. As we will discuss later, the current lack of investment options implies significant opportunities to unlock investment capital by way of innovative financing solutions that can more easily match the needs of investors.

**FIGURE 1. INVESTOR RESPONDENTS BY ORGANIZATION TYPE**



Source: J.P. Morgan, 2013

The industry’s focus on private debt and private equity is also indicative of the nature of investee companies. Impact enterprises are typically in the early stages of applying innovative business models to simultaneously enhance operating profitability and address a social or environmental need. In order to scale and prove the viability of their business model, these businesses generally require a form of patient capital from sources that value their impact potential over and above their long-term earnings prospects. Since their business is unproven, private forms of capital allow the business to further develop its opportunities and establish more firmly its cash flows and revenue streams.

**TABLE 1. INSTRUMENT TYPE OF REPORTED INVESTMENTS**

	NUMBER OF TRANSACTIONS	%	NOTIONAL (USD, MILLION)	%
Private debt	1,345	61%	2,296	52%
Bilateral loan agreement	152	7%	191	4%
Deposit	106	5%	70	2%
Guarantee	10	0%	73	2%
Equity-like debt	48	2%	78	2%
Public debt	1	0%	2	0%
Debt (sum of above)	1,662	75%	2,710	62%
Private equity	548	25%	1,655	38%
Public equity	2	0%	10	0%
Equity (sum of above)	550	25%	1,665	38%
Real Assets (reported)	1	0%	2	0%
Total	2,213	100%	4,377	100%

Source: GIIN, 2011

To illustrate the power of the impact industry, it is useful to consider a few prominent examples. The four examples that we present in Box 1 demonstrate the wide-ranging nature of impact investments in terms of social, environmental and economic impact narratives, investor motivations, financial instruments, direct and indirect investment methods, risk profiles, earnings prospects and so on. They also demonstrate the wide-ranging applicability of the impact model across various sectors, including agriculture, energy, microfinance and infrastructure. We will dig deeper into the heterogeneous profiles that comprise the impact investment space later in this paper, especially as it relates to implications for scale and pension and sovereign funds’ involvement in the space. In the next subsection, we also discuss the sectorial focus of investors, as well as their approach to asset allocation and investment selection for impact investing.

## BOX 2: PROMINENT IMPACT INVESTMENT EXAMPLES

The following are a few prominent examples of successful impact investment deals made through private forms of debt and equity capital.

1. **Mtanga Farms (Agriculture):** Four investors (Calvert Foundation, Tony Elumelu Foundation, Heirs Holdings and Lion's Head Global Partners) partnered with Mtanga Farms management to help rehabilitate agricultural land, enter a promising new market to sell-high quality potato varieties for use as seed material and replace lower-quality seeds to produce higher yields for smallholder farms. Located in Tanzania, Mtanga Farms covers 2,500 hectares and employs over 100 permanent and seasonal workers. It was founded by two local entrepreneurs who identified an opportunity to meet a need for disease-free seed potatoes by farmers in their country, where there were 150,000 smallholders cultivating potatoes. In order to diversify its revenues, the enterprise also decided to raise cattle and sheep, and grow crops such as barley, maize, soya and wheat, which it sells in local and regional markets. The enterprise raised USD\$2 million in two initial rounds of financing. More recently, a third round was conducted and an additional investment of USD\$1.5 million was raised from the Voxtra East Africa Agribusiness Fund. The company is well positioned to create substantial social impact through the benefits to smallholder farmers and its contribution to food security. Smallholder farm potato yields are expected to triple due to the new seed variety that is being introduced due to the efforts of Mtanga Farms.
2. **Husk Power (Energy):** In 2007 two Indian entrepreneurs succeeded in producing synthetic gas from rice husk, which is a readily available waste product in India, and were able to produce electricity with this new source of energy, which they brought to a remote urban village (Bihar) for power and lighting. They then successfully built two working power plants and demonstrated the viability of their core technologies in serving off-grid villagers. Since 400 million people—one third of the Indian population—do not have access to electric power sources, the innovation had significant financial and impact potential. To scale the solution, Husk Power initially obtained grants from Shell Foundation, permitting it to build 11 more plants. In 2009 Husk Power undertook a round of financing and successfully raised over \$1.5 million from four investors (Bamboo Finance, LGT Venture Philanthropy, DFJ/Cisco and Acumen Fund). The International Finance Corporation committed USD\$1.5 million in the following year, and with continued financial support from the Shell Foundation (an additional USD\$1.65 million in grants was provided), Husk Power grew to being able to serve electricity to over 25,000 households (150,000 people) in 250 hamlets and villages. Each of the company's 75 operational mini power plants achieved break-even on average within six months of starting operations, and Husk Power is now in a position to expand in Africa and other segments of the energy sector. Within the next five years, Husk Power hopes to deploy 2,000 plants across the rice belt, serving an additional 5 million people.
3. **Masdar City (Infrastructure):** The Abu Dhabi government is using one of its smaller sovereign wealth funds, Mubadala (USD\$50 billion), to finance the development of "Masdar City." It is a multi-billion dollar project in which money from the sovereign wealth fund will be used to develop the "green economy" and support other strategic objectives, including job creation, economic growth and the development of a knowledge-based economy. The city will rely entirely on solar energy and other renewable energy sources, and will comprise of a vibrant cleantech cluster. In particular, Persian Gulf sovereign wealth funds may use impact investing via Islamic Finance principles to drive socioeconomic development.
4. **Grassroots Capital (Microfinance):** As a means to diversify its private equity holdings, ABP, which is the largest Dutch pension fund, invested USD\$30 million in a microfinance fund ran by Grassroots Capital. As of April 2010, the date of this investment, ABP's microfinance investments amounted to USD\$215 million in debt and private equity. This equity investment was part of the Grassroots Capital's Global Microfinance Equity Fund, which closed at USD\$117.5 million, to be invested in up to fifty separate microfinance institutions in parts of the world where access to financial services is limited. Such investments promote financial inclusion and improve household cash flows and living standards, all while producing financial returns for investors. PGGM, the Netherlands' second biggest pension fund, also contributed.

Sources: GIIN (2011); Husk Power Systems Private Limited (2012); Masdar Mumbra Company (2006).

## 1.2 Where Are Impact Investments Made?

As impact investments are typically targeted to benefit the poor population, the disadvantaged or the natural environment, developing and low-income countries account for a large portion of reported investments. However, impact investments are increasingly being made to stimulate economic growth, promote green economies and generate jobs through infrastructure projects and other initiatives.

Impact investments can be profitable, especially when made in developing and low-income countries where economic growth prospects are particularly attractive and where a large stratum of the population have underserved needs. In addition, economic growth and social well-being are increasingly constrained by limitations imposed by dwindling resources and rising commodity prices. Therefore, impact enterprises that enhance the environmental and social efficiency of business ecosystems are positioned to create substantial economic value. The emergence of green growth policies and inclusive economies in these countries supports the proposition that an enterprise seeking to create social and environmental impacts through novel business models will become increasingly competitive and profitable as current unsustainable patterns of consumption and production continue to deplete environmental and social capital.

In developing and low-income countries, an investment is defined as having an impact if it generates a benefit at the “bottom of the pyramid” (see Box 1), since poverty is an important determinant of a population’s access to services such as education, healthcare, nutrition, financial services and housing. Other factors are the limitations of the public sector, foreign aid and civil society to efficiently deliver solutions at scale. Where there is insufficient public infrastructure, there are opportunities for the private sector to create and deliver scalable solutions, especially among this lower-income segment. Furthermore, by promoting co-investments from civil society, the government and the private sector, the diversity of investors will bring complementary resources that will enhance the performance of the impact enterprise (we discuss this point further in the following sections). Increasingly, development institutions such as the Asian Development Bank and the African Development Bank tend to support projects across a wider range of sectors, including infrastructure, transport and trade. Thus, expanding the impact investment focus of private sector investors to these sectors can effectively generate a variety of positive social, environmental and economic outcomes, especially if resources are combined with civil society and governments.

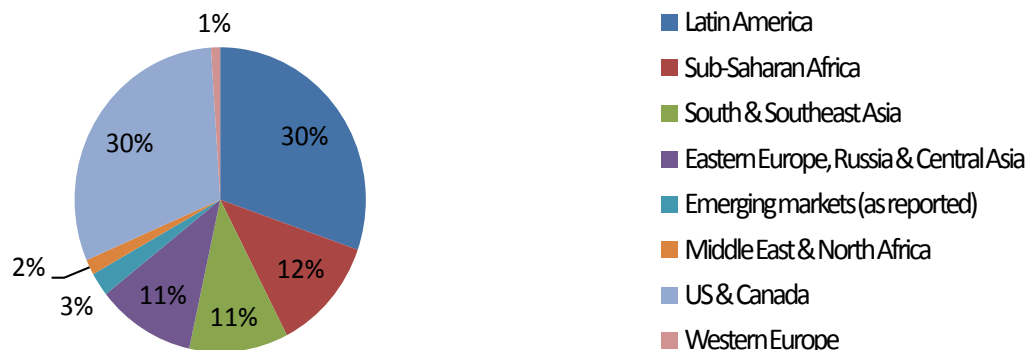
An analysis of popular impact investment funds has revealed that most investments are made in financial services (including microfinance), community development, healthcare and nutrition, while very few are made in energy, education, transportation and infrastructure. Consider the following sectorial representation of the major impact investment funds (Table 2).

**TABLE 2: NUMBER OF PORTFOLIO COMPANIES BY SECTOR IN MAJOR IMPACT FUNDS**

	FINANCIAL SERVICES (INCL. MICROFINANCE)	COMMUNITY DEVELOPMENT	HEALTHCARE	NUTRITION	ENERGY	EDUCATION	OTHER
Aavishkar	7	6	4	2	1	1	21
Bamboo Finance	4	1	2	1	2	1	11
Acumen	0	5	15	9	3	0	32
GrassRoots Capital	4	9	0	8	0	0	21
<b>Total</b>	<b>15</b>	<b>21</b>	<b>21</b>	<b>20</b>	<b>6</b>	<b>2</b>	<b>85</b>
<b>Percentage</b>	<b>18%</b>	<b>25%</b>	<b>25%</b>	<b>24%</b>	<b>7%</b>	<b>2%</b>	<b>100%</b>

Source: Arosio, 2011

Developing and low-income countries abound with opportunities to profitably serve social and environmental needs that are unmet by governments and civil-society. In 2011 the world’s 52 largest impact investors made most of their investments in developing countries, with Latin America and sub-Saharan Africa representing the largest inflow of investment deals (J.P. Morgan, 2011). Of a total number of 2,106 impact investment deals made that year, 1,421 (67 per cent) were made in emerging markets. However, emerging market deals tend to be smaller, and therefore they accounted for 44 per cent of the global notional amount of funds invested. A more recent survey has identified that investors are increasingly looking for deals in sub-Saharan Africa (34 per cent of respondents), Latin America and the Caribbean (32 per cent of respondents), East and Southeast Asia (27 per cent of respondents) and South Asia (26 per cent of respondents).



**FIGURE 2. REGIONAL DISTRIBUTION OF REPORTED INVESTMENTS**

Source: J.P. Morgan, 2011

Due to their relative ease of investment and theses that are relatively less risky and easier to understand, microfinance and housing have historically dominated the impact investment industry, with these sectors accounting for 37 per cent and 21 per cent, respectively, of the total funds invested in 2011 (J.P. Morgan, 2011). However, the food and agriculture sector (6 per cent of total funds) and clean energy and technology (6 per cent of total funds) each represented a significant nominal amount and over one quarter of all deals made that year. It is also noteworthy that the large majority (85 per cent) of investments were made into companies rather than funds. Additionally, while some investors specialize in one particular sector to leverage a competitive advantage (as is the case with fund managers in particular), others seek to diversify their exposure to avoid concentration in one sector and lower portfolio risks.

A forward-looking survey of the 99 largest impact investors has found that a wider set of investment opportunities is presently being sought, with food and agriculture and healthcare investments considered areas with significant potential by over half of the respondents. Over a third of respondents reported being on the lookout for opportunities in the financial, microfinance, education, housing, energy and cleantech sectors. This broader forward-looking sectorial focus is indicative of the ongoing expansion of the impact industry.

### 1.3 What is the Process for Investors’ Asset Allocation and Investment Selection?

Impact investors can be classified as either “financial first” or “impact first.” Financial-first investors seek to achieve impact as long as financial returns are above a certain floor. Impact-first investors seek to maximize impact with a floor financial return. The focus of this paper is on the former, which seeks to attain social and environmental impact as long

as the investment can be expected to achieve a certain minimum of return on investment or capital appreciation as required by the fiduciary responsibilities of the fund. In particular, we are interested in pension and sovereign wealth funds due to their sizeable share of global assets under management. The strategy of impact investors is guided by two overarching components:

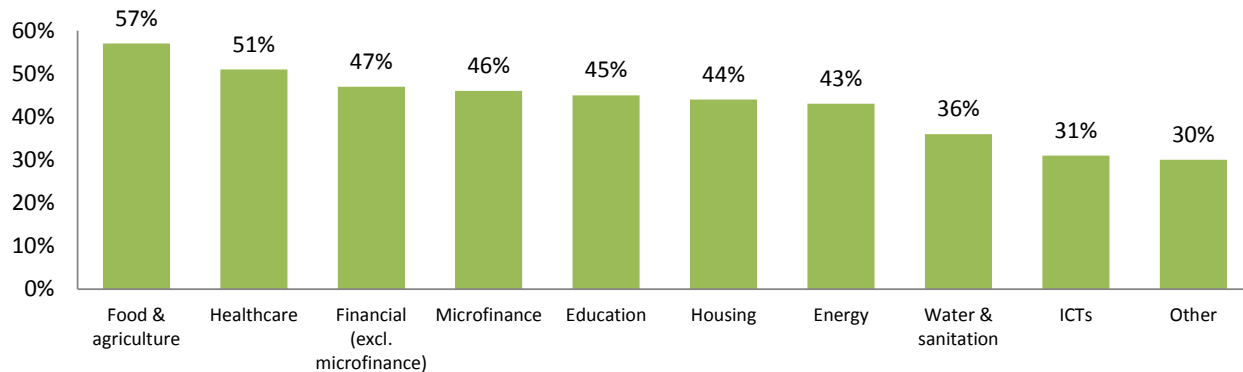
1. An investment thesis, which states the fund’s intentions towards delivering a given rate of return while simultaneously generating an environmental or social impact (e.g., to select investments that will deliver a reasonable rate of return while contributing to food security in developing and low-income countries).
2. An impact thesis, which states the fund’s intended approach to delivering the stated impact by way of investment (e.g., to contribute to food security in developing and low-income countries by investing in enterprises that enhance the productivity of smallholder farmers in these countries through the provision of innovative products and services).

For financial-first investors, the investment and impact theses of an impact investment portfolio are developed at the strategic level of the fund. From these parameters, a scope for the investable universe is determined and investment opportunities are sought that align with the intent of the impact thesis and set out metrics by which to measure the success of investments over relevant time horizons. An investor may have several investment and impact theses that guide its investment selection processes. A thesis may be broad and crosscutting, as in the case where the objective is to help the BoP population, thus also broadening the investment universe across multiple sectors and geographies.

**TABLE 3: IMPACT OBJECTIVES**

SOCIAL IMPACT OBJECTIVES	ENVIRONMENTAL IMPACT OBJECTIVES
Access to clean water	Biodiversity conservation
Access to energy	Energy and fuel efficiency
Access to financial services	Natural resources conservation
Access to education	Pollution prevention & waste management
Access to information	Sustainable energy
Affordable housing	Sustainable land use
Agricultural productivity	Water resources management
Capacity building	
Community development	
Conflict resolution	
Disease-specific prevention and mitigation	
Employment generation	
Equality and empowerment	
Food security	
Generate funds for charitable giving	
Health improvement	
Human rights protection or expansion	
Income/productivity growth	

Source: IRIS, n.d.



**FIGURE 3. SECTOR INVESTMENT FOCUS OVER THE COMING YEARS**

Source: J.P. Morgan, 2013

The drivers of target returns and risks in achieving those returns typically determine the scope of the investment universe. Investors then assess each opportunity individually to determine what factors (e.g., costs, volumes, demand, competition) might drive investment performance, given the impact thesis. As is usually the case, investments will be selected from this initial screening on the basis that there is a positive correlation between the intended social impact and the financial return of that investment. Additional financial parameters that the fund might consider include the type of financial instruments, the geographies and sectors of focus, the growth stage and scalability of the enterprise, and the risk appetite of the investor. From this foundation, the process for selecting investments is similar to the traditional approach, including the consideration of company, country and investment risks. Some investors will decide to invest directly into the impact enterprises, while others will choose to employ intermediaries and external fund managers. Here as well, traditional analyses and due diligence applies.

**BOX 3: PGGM'S IMPACT STRATEGY**

PGGM is a leading Dutch pension administrator with its roots in the healthcare and social work sector. It has a six-pillar general responsible investment policy, which includes targeted environmental, social and corporate governance (ESG) investments as one of its pillars. Targeted ESG investments are selected according to their potential to not only contribute financially to the portfolio's performance for the economic benefit of clients, but are also intended to create social value that aligns with the conventional definition of impact investing. As a result, PGGM has a sub-portfolio of targeted ESG investments that seeks to consciously address social themes like climate change and poverty. Its various investment teams are responsible for selecting individual investments in line with these themes with the support of the Responsible Investment department. In 2011, PGGM increased its commitment to targeted investments to EUR47 billion or 4.1 per cent of total assets under management. Targeted investment in PGGM's portfolio include microfinance, renewable energy (structured credit), cleantech (private equity), infrastructure projects (mezzanine finance), commodities (carbon credit) and direct investment in the International Finance Corporation (IFC) African, Latin American and Caribbean Fund to enable economic growth in these countries and support the private sector in creating jobs.

Source: PGGM (2011)



## 2.0 The Problem with Impact Investing

Financial-first investors like pension funds, conventional mutual funds and sovereign wealth funds have a fiduciary duty to represent the best interest of their clients and beneficiaries. This duty is primarily defined as a duty of loyalty and impartiality toward these parties. As a result of this legal mechanism, the administrators of these funds must, as fiduciaries, refrain from making decisions that would benefit themselves or third parties over beneficiaries or clients. Fiduciaries are also required to act with prudence and care when making investment decisions to tailor their portfolio to suit their unique investment objectives (Pacific Community Ventures and the Initiative for Responsible Investment, 2012). For example, the duty of prudence requires an adequate level of diversification, and other considerations both at the level of the portfolio and individual investments. These duties and the standard of care are consistent across institutional investors.

These investors must thus approach the investment and administration of their funds within the constraints of fiduciary duty, interpretations of portfolio and investment theory, and the complexities of executing their investment strategies, including through the involvement of third party service providers (PGGM, 2011). The most prominent tenet of these responsibilities is Modern Portfolio Theory, which, as currently implemented, requires the evaluation of investments on a limited number of factors (risk and return), and encourages funds to benchmark their performance to asset-class specific measures (indices) that compare the investments' performance to these factors.

The implications of these norms on institutional investors are the following (Pacific Community Ventures and the Initiative for Responsible Investment, 2012):

1. Benchmarking tends to favour standardized opportunities over innovative ones, and emphasizes the short-term performance of an investment. As a result, impact investments may be disfavoured because of their lack of track record and their representation as an idiosyncratic, niche investment.
2. Modern Portfolio Theory disregards the long-term health of a business and its broader impact on society. Although these aspects may be factored in to the decisions of fund administrators and investors implicitly as far as they are perceived as being linked to the short- to medium-term performance of an investment, it does not take into account the greater sustainability implications that may in fact have positive financial or non-financial significance.

Given these implications, to overcome barriers to scale and encourage greater participation by pension and sovereign wealth funds in the impact investment industry, the following problems should be addressed.

**TABLE 4: PROBLEMS TO BE OVERCOME FOR SCALABILITY AND PARTICIPATION**

PRIMARY PROBLEMS	SECONDARY PROBLEMS
Shortage of impact investment deals	Impact measurement
Impact investment track records	Blended capital curve
Exit options	Scalability
	Sourcing deals/investment costs

We discuss these problems in the subsections that follow, and address possible solutions by way of promising government initiatives and innovative financing models in sections 3 and 4, respectively. We also apply this outline

to the Indian impact enterprise ecosystem, and suggest how an ecosystem approach may be used to assess the conduciveness of government and financial industry initiatives to build and expand the impact investment pipeline at the country level.

It is noteworthy that a recent survey by J.P. Morgan (2013) that asked 99 of the largest impact investors about the most critical challenges to industry growth found that the “lack of appropriate capital across the risk/return spectrum,” the “shortage of high quality investment opportunities with track record” and the “difficulty exiting investments” are the three challenges that investors currently perceive as being the most significant.<sup>1</sup>

**TABLE 5: THE MOST CRITICAL CHALLENGES TO THE GROWTH OF THE IMPACT INVESTING INDUSTRY TODAY**

RANK	SCORE	AVAILABLE ANSWER CHOICES
1	143	Lack of appropriate capital across the risk/return spectrum
2	140	Shortage of high-quality investment opportunities with track record
3	76	Difficulty exiting investments
4	58	Lack of common way to talk about impact investing
5	53	Lack of innovative deal/fund structures to accommodate portfolio companies’ needs
6	48	Inadequate impact measurement practice
7	44	Lack of research and data on products and performance
8	32	Lack of investment professionals with relevant skills

*Number of respondents = 99. Respondents ranked the top three. In presenting the results, the ranks and the score for the answer choices are shown in order to show how close the rankings are. Scores are calculated as follows: (number of respondents that ranked it first × 3) + (number of respondents that ranked it second × 2) + (number of respondents that ranked it third × 1).*

*Source: J.P. Morgan, 2013*

## 2.1 Shortage of Attractive Impact Investment Deals

Investors seeking to allocate capital to the impact investment sector report a shortage of deals that meet their required rate of return. Given that financial-first investors typically seek market rate returns, prospective investments that are not competitive relative to conventional benchmarks typically get screened out. Even though some investors may be willing to make impact investments, the shortage of competitive investments that meet their criteria has resulted in a shortage of adequate supply in the impact investment sector. These conditions result in a market gap, which can be understood conceptually as the difference between the supply of capital that may be readily invested in impact, and the availability of investment opportunities that meet the criteria for investment.

Without a sufficient number of deals that meet the risk and return requirements of investors, large amounts of capital are sitting on the sidelines. This type of supply gap is particularly evident in the inclusive business space where enterprises operating at the BoP that propose a market-based approach to solving the problems of poverty have financial propositions that can be especially elusive. The experience of Acumen Fund has reflected this reality: out of 5,000 companies considered for investment in the past 10 years, Acumen invested in only 65 (Monitor Group,

<sup>1</sup> Relative to a survey done two years earlier. “Difficulty exiting investments” rose from sixth to third and was replaced by “inadequate impact measurement practice.”

2012). A study by the Monitor Group conducted over 16 months across nine countries in sub-Saharan Africa found that of 439 promising inclusive businesses, only 32 per cent were commercially viable with the potential to achieve scale and only 13 per cent were actually operating at scale (Kubzansky, Cooper & Barbary, 2011). The companies reviewed for this study faced a number of obstacles, such as selling to a customer base that is hard to reach and whose resources are severely limited, dealing with suppliers that have limited capacities, highly volatile production and low consumer loyalty. These are in addition to the challenges inherent in operating a small business in Africa, such as difficulty in accessing finance, human capital, achieving economies of scale, creating trusted brands, and dealing with poor infrastructure and inefficient regulation.

Impact investors have reported using the following benchmarks when targeting market rate returns: Cambridge Associates venture capital vintage year benchmarks, Cambridge Private Equity Index, LIBOR, MSCI Emerging Markets Indices, Consumer Price Index and Barclays U.S. Aggregate Bond Index (J.P. Morgan, 2013). The lack of competitive impact investments relative to these benchmarks suggests an opportunity for financial product innovations. Investors also believe that support from governments to impact investors and the broader market could encourage more capital across the risk/return spectrum by implementing tax credits and subsidies, for example, or with technical assistance to both the impact enterprises and investors, which could help mitigate business risks (J.P. Morgan, 2013).

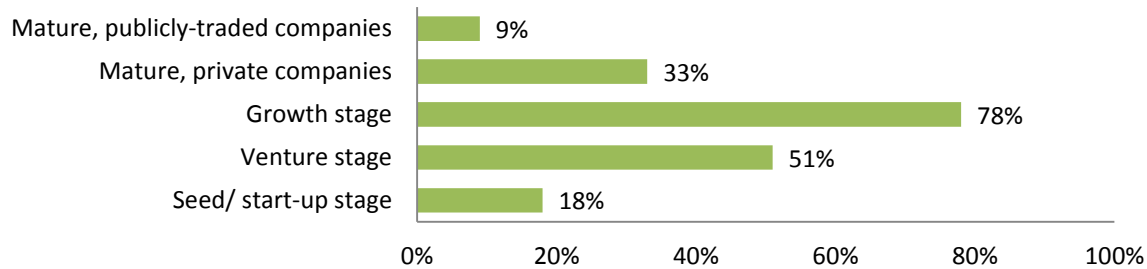
In addition to fiduciary requirements of risk and return, certain institutional investors will only consider deals of a certain size. Although microfinance and affordable housing segments can meet size requirements, smaller direct investments would benefit from innovative financial solutions. New deals in infrastructure and green real estate may more easily benefit from such innovations (Rockefeller Foundation, 2012).

## 2.2 Investment Track Records

Most investors seek impact investments that are in the growth stage (79 per cent of survey respondents) or the venture stage (51 per cent of survey respondents) and mature private companies (33 per cent of investors surveyed), according to a study by J.P. Morgan (2013). These tendencies suggest a low appetite for risk and a disposition towards investments with a sufficient track record and capacity development to demonstrate “investment-ready” status and a likelihood to generate sufficient returns.

Without such a track record, the internal infrastructure and the capacity to execute business models needs to be built in a process that may be supported by investors using a traditional venture capital or private equity approach. Grant-funded technical assistance and various other hybrid approaches that integrate a combination of business and industry-sector expertise can also be used. However, building this “investment readiness” for seed and early-stage ventures is a risky endeavour that is costly and not likely to yield high return, especially in the short to medium term.

Therefore, the shortage of such “investment-ready” companies is one of the major factors preventing financial-first investors from becoming more involved. The subsections on “blended capital curve,” “scalability” and “sourcing deals” below will expand upon this challenge.



**FIGURE 4. STAGE OF COMPANY DEVELOPMENT AT WHICH INVESTORS PREFER TO INVEST\***

\*Number of respondents=93; respondents chose all that apply

Source: J.P. Morgan, 2013

## 2.3 Blended Capital Curve

Financial-first and impact-first capital can be layered on at various stages of an impact enterprise’s development. This strategy may be critical for the development of the industry. Impact-first investors like venture, philanthropists and governments can provide early-stage financing that delivers low return, high risks but high social or environmental impact; financial-first investors can follow-up with larger investments at greater scale when proof of business has been made (Rockefeller Foundation, 2012). Initial impact-first financing can be in the form of grants, technical assistance and below-market debt, while later stage financing can be approached through innovative fund structures.

Such innovations in fund structures are important to unlock large-scale investments in the industry, and may be achieved by aligning the risk, return and impact preferences across investor segments. A small number of such “yin yang” deals have been made so far, but have tended to be driven mainly by impact-first investors. The Husk Power enterprise, which we outlined in Section 1, is one of the few examples of investors successfully overlaying and phasing-in grant, concessional and commercial capital at various stages. The biggest challenge to such deals has been the costs of specialized intermediaries to bring together and structure the various investors and sources of capital.

## 2.4 Scalability

Impact enterprises are often required to apply business models that are unproven, thus introducing an additional level of risks and adding only marginally to their chances to achieve production and profitability levels that are comparable to industry competitors in their sector.

Various barriers exist that prevent impact enterprises to scale, with commensurate consequences on financial returns. In particular: BoP market deals with high-risk customers and volatile suppliers that introduce substantial levels of management and financial risks; significant efforts are needed to educate consumers and create demand; a dispersed BoP segment represents a significant challenge for distribution channels; and high transaction costs related to informal business methods.

Acumen Fund reports that its portfolio companies have net operating margins that average -20 per cent, while its eight most profitable investments have recorded an average after-tax profit of only 6 per cent (Monitor Group, 2012). A study of 50 inclusive businesses in Africa has found profit margins to be between 10 and 15 per cent (Monitor Group, 2012). Returns from microfinance sector investments, however, have proven to be higher. While these results are in line

with their impact aims, they are incompatible with the expectations of financial-first investors. A combination of low profit margins and significant challenges for business scalability invariably results in low return on investment.

Despite this challenging context, some business models have proven to be conducive to some level of success. Two comprehensive studies by the Monitor Group have highlighted seventeen models that should be sought for their ability to generate financial returns and the International Finance Corporation’s experience with 200 enterprises representing USD\$5 billion of investment in their impact portfolio has highlighted seven promising models (see Box 4). By targeting these models, investors may enhance their likelihood of achieving competitive returns. The following three investment strategies have proven successful in that regard (Kubzansky, Cooper & Barbary, 2011):

1. A traditional organic approach based on innovation, growth and reinvestment and/or a “Silicon Valley” approach involving sustained investments in probable winners.
2. Replicating, disseminating and transplanting proven business models.
3. Upgrading ventures that are already at or near scale in the informal economy.

As noted by a recent evaluation of the Rockefeller Foundation, there is an assumption that if more investors are searching for these business models and if that capital could be allocated in a more efficient manner, as suggested by the strategies outlined above, then there would be an ample set of opportunities to place these investments. However, leading investors struggle to identify “investment-ready” opportunities and struggle to realize deal flows at scale.

**BOX 4: THE IFC’S EXPERIENCE WITH SCALABILITY**

The International Finance Corporation (IFC) provides over 200 inclusive businesses with investment solutions and advisory services to help them address the toughest operational challenges and market conditions. In five years, the IFC has provided these companies with over USD\$5 billion in investment capital to help them accelerate the growth of their businesses. A recent systematic review of its experience with these companies has identified seven business models with a proven ability to scale.

1. **Micro distribution and retail (beverage, consumer products and mobile telecommunication sectors):** Reaching BoP consumers, who tend to make small, frequent purchases close to home, by leveraging and effectively serving existing retail outlets in the neighbourhoods where they live, rather than building their own retail chains.
2. **Experience-based customer credit (companies outside the financial sector):** Generating additional revenue in the form of interest income through lending to customers the company knows are creditworthy through experience doing business with them in the past—rather than formal credit histories—and leveraging the existing relationship to help incentivize repayment.
3. **Last-mile grid utilities (water and electricity services sectors):** Extending grid coverage to more distant and lower-income neighbourhoods through a combination of financing, technology and customer service innovations that help cover capital expenditures, minimize technical and commercial losses, and ensure that customers pay on time.
4. **Smallholder procurement (food and agriculture sectors):** Providing geographically dispersed smallholders with aggregation methods and customized packages of support services (e.g., agricultural extension, business development, access to agricultural inputs, and credit) that build capacity and loyalty, and promote their ability to provide consistent, reliable supply. Complementary models include smallholder financing and agricultural market information systems.

5. **Value-for-the-money degrees (education sector):** Making university education accessible to all through a combination of innovations (e.g., standardized curricula, physical and virtual campuses, modular programming and loan financing) that increase affordability and value for lower-income students.
6. **Value-for-the money housing (financial sector):** Making home ownership possible for lower-income buyers through a combination of high value for money and facilitated access to mortgage financing. Complementary models include inclusive mortgage financing.
7. **e-Transaction platforms (technology sector):** Providing electronic transaction platforms that promote convenience, efficiency, security, market access and integration into the formal financial system, enabling a cashless society to function. Many of these solutions leverage existing retail outlets and networks, building outlets' business and technology skills and raising consumer awareness.

The IFC distilled a set of common success factors among business models that have demonstrated an ability to scale. According to their experience, maximizing impact and financial returns typically hinges upon the ability of the business model to:

- Create value for BoP suppliers, distributors, retailers, consumers and every stakeholder at every stage of the value chain. While cost sharing and reduction may be critical, the willingness to pay (for customers) or invest (for suppliers, distributors and retailers) is the foundation of a scalable model.
- Not only offer a strong value proposition, but also take action to raise the target group's awareness and appreciation of it—employing a high-touch approach to their market is necessary to create demand and acquire and retain customers.
- Reconcile the high-touch requirements and low price-point imperatives of low-income consumers by employing cost structures that enable high profit margins that will help cover the costs of stimulating demand, capacity building and other high-touch aspects of their business.
- Strategically use public funding to deepen the BoP market or help defray the cost of high-touch activities.

More information on these findings can be found by accessing their report, which is available at [here](#).

Source: IFC (2011)

## 2.5 Sourcing Deals/Investment Costs

The challenges listed above point to a need for more concerted efforts to build a pipeline that will deliver “investment-ready” enterprises that align with the risk/return/impact preferences of financial-first investors.

Being investment-ready requires the demonstration of an enterprise's capacity to implement a given business model at scale and thus increase the likelihood that impact and financial returns can be maximized for the investor. Achieving such a stage of development, however, takes time and investment, but few, if any, financial-first investors can see a viable reason to be involved in assisting early-stage enterprise development due to the high risks/low returns associated with the activity. In addition, a large amount of resources are spent on deal sourcing, an activity in which one searches for prospective investment deals, assesses “investment-readiness” and the investment theses of companies.

Given the high level of alignment between impact-first (e.g., philanthropic organizations, foundations, nonprofits, high-net worth individuals, development finance institutions), financial-first (e.g., pension and sovereign wealth funds, fund managers), governments and civil-society organizations, there is significant opportunity for collaboration across deal sourcing and company development activities. Incorporating these actors' various skills and interests into a global deal-sourcing system can facilitate economies of scale, reduce search and transaction costs and significantly strengthen

the pipeline necessary for scaling up “investment-ready” deals. Examples to be followed include Toniic, which is an investor-led platform that allows impact investors to pool resources and share sourcing and due diligence costs and Village Capital, which supports impact enterprises in their efforts to build early-stage capacity and engages them in the due diligence process.<sup>2</sup>

However, these networks are currently fragmented and largely exclude financial-first investors such as pension and sovereign wealth funds with important amounts of capital. So far, there exists little evidence that these networks have effectively integrated deal sourcing and capacity building across relevant actors in any systematic manner.

## 2.6 Impact Measurement

J.P. Morgan’s 2012 survey found that out of 99 impact investors surveyed, 96 per cent measure their social and/or environmental impact, and four out of five fund managers highlight the importance of impact measurement for raising capital. These investors reported spending 10 per cent of their time on impact measurement (at the median). Moreover, 70 per cent of respondents believed that standardized impact metrics are “important” or “very important” for the development of the industry.

Most impact investors have clearly defined investment themes or parameters, such as cleantech, inclusive business and environmental consumer products. Impact measurement is especially important at the due diligence stage, as it allows the appropriate screening of investments according to these themes. Once investments have been made, investors will continue to monitor and report impact performance to ensure the continued alignment of the investment’s performance with their objectives.

Despite the importance of impact measurement, most investors report a sense of frustration about “what constitutes a robust or actionable methodology” for measuring impact (Thornley & Dailey, 2012, p. 25). The lack of commonly accepted standardized metrics has caused many investors to use customized proprietary measurement systems, especially since their investment preferences often differ significantly from their peers. This approach, however, has proven costly, as it requires a significant amount of staff time, which could otherwise be used towards other activities that may be more valuable, such as trying to keep a certain venture afloat.

Another challenge is the lack of reliable data on the impact performance of investments from publicly available sources or third parties. Although some information services exist, such as the Community Development Financial Institution Assessment and Rating System (CARIS), Global Impact Investing Rating System (GIIRS), Microrate and Planet Rating, many impact enterprises, especially in developing countries, produce little information on their social and environmental performance, and data reliability is a problem.

## 2.7 Exit Options

Since most investments made in the sector are private equity or private debt (about 90 per cent according to a J.P. Morgan survey [2011b]), impact investments are relatively illiquid, causing a critical barrier for many investors. Due to the nature of impact enterprises, the most frequently realized exit methods have been either share buy-backs by the enterprise or the sale of the entire business to a strategic buyer. Whereas the most typical route for liquidity for

<sup>2</sup> Governments can also play an important role; in the 2013 J.P. Morgan survey, technical assistance for investee companies was seen as the government policy that would be most helpful for impact investors.

a venture-backed company in the traditional financial markets has been initial public offerings (IPOs), this route has historically been off limits for most impact enterprises, in part because of the nascence of capital markets in developing and low-income countries.

In some developing countries with deeper capital markets, IPOs have been used as an exit strategy in the microfinance sector. Nevertheless, the possibility that micro financial institutions (MFIs) may contemplate raising equity by public offering has attracted fierce criticism. In 2007 Compartamos, the largest microfinance bank in Latin America, controversially raised USD\$467 million from the issue of an IPO, earning large returns for private investors without raising any additional capital (Bloomberg Business Week, 2007). Compartamos attracted fierce criticism in the wake of the IPO for enriching wealthy private investors with returns on equity of 53 per cent. The main criticism about IPOs as a viable exit strategy for impact investments is that using them may be placing shareholders' interests ahead of the impact target.

The lack of liquidity is an added source of risk, because investors cannot easily divest themselves of their holdings. In a 2013 J.P. Morgan survey of 99 impact investors, 86 per cent of respondents had either a strong (48 per cent) or a moderate (38 per cent) interest in investment structures and structural features that promote liquidity, while 74 per cent had either a strong (42 per cent) or a moderate (32 per cent) interest in investment structures and structural features to promote principal protection. Fund managers will typically negotiate liquidity and exit options prior to investment as part of the due diligence process. Self-liquidating structures are one method that may be used in this context. However, to encourage more involvement in the impact sector, other mechanisms, like the creation of secondary markets and publicly tradable securities, should be promoted. For example, at the end of 2010, Symbiotics, a Swiss microfinance investment and small and medium enterprises (SME) impact investment services company, launched the first Impact Investment Bond Issuance Platform for Institutional Investors. By doing so, they set the ground for secondary market transactions on impact investment bonds. Even though these types of bonds are still in their early stages and their average daily trading volume is still very low, micro small and medium enterprises (MSME) bonds are a supervised vehicle in Luxembourg settled through Euroclear/Clearstream with market-driven pricing. Symbiotics plays the role of a market maker, buying and selling the bonds according to the investors needs, and in doing so, ensures liquidity to institutional investors who want to exit their investments.



## 3.0 What Governments Can Do

Governments are well positioned to provide support to impact enterprises and impact investors. With the seven impact investment challenges in mind, we present the context in which governments can facilitate greater investment from investors like pension and sovereign wealth funds seeking a reasonable return.

### 3.1 Plumbing and Housekeeping

Since impact investments are made within a developing or low-income country's political and macroeconomic context, it is important to emphasize that the performance of impact investments and, consequently, the investment decision-making, are significantly affected by the external and country-specific factors that apply. Particularly with pension and sovereign wealth funds and their fund managers, these factors may be incorporated into formal processes that determine the investment attractiveness and the investability of emerging market countries. For example, the California Public Employees' Retirement System had a policy in place from 2002 to 2007 that effectively prohibited internal and external fund managers from investing in certain emerging countries based on an assessment of the country's macroeconomic and political stability, market regulation and liquidity, labour practices, capital market openness, settlement proficiency and transaction costs, as well as other sustainability factors.<sup>3</sup>

Research by the World Bank that looked at the investment allocation process employed by institutional investors in emerging markets proposes that their decision-making process is mainly influenced by a number of factors related to the quality of "housekeeping" (macro policies, political economy, local financial markets, corporate governance standards, etc.) and the efficiency of "plumbing" (legal and regulatory frameworks, custody, clearing and settlement, taxes, etc.) (Zervos & Ladekarl, 2004).

Although it is acknowledged that the most profound effects on investment flows, or the required minimum expected returns, arise from the improvement or deterioration of macroeconomic policies, policy initiatives by governments in these countries can, for a given macroeconomic situation, improve investment attractiveness and draw in investment flows. To attract investment flows, countries should foster housekeeping factors such as strong macroeconomic policies that are geared towards enhanced growth and stability, and predictable political regimes that foster human and economic development. Plumbing factors that facilitate greater investment include issues such as quality information about the country's economic and political situation, adequate settlement and registration facilities and the quality of the local financial markets.

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<sup>3</sup> Of note, the policy resulted in an inability to invest in the booming equity markets of Russia and China, so CalPERS modified its approach in late 2007.

**BOX 5: HOUSEKEEPING AND PLUMBING ISSUES AFFECTING INVESTMENT ATTRACTIVENESS**

**Housekeeping issues:**

- Macroeconomic conditions include inflation, growth forecasts, trade and current account, fiscal balance, the exchange rate regime, and the general composition of the economy in terms of industrial base and natural resources.
- The political environment and the political stability of a country can also be an influential indicator. If a country's direction of future policy and leadership are easier to understand, then investors can more confidently assess the probabilities of economic growth and the country's intentions to pay its debts.
- The stability of the local financial system, especially the banking system and securities markets, is of concern to investors because countries in financial crisis will limit the ability of investors to make transactions. However, as is often the case with impact investors and large institutional investors, hard currency investments will suffer less from a financial crisis than those made through local currency.
- A large local investor base is seen as beneficial due to informational and lower funding risk effects. Lastly, corporate governance standards—including shareholder rights, disclosure and transparency and the role of the board of directors—also play a part both on an individual company level and in terms of the requirements put in place at the country level.

**Plumbing issues:**

- Plumbing factors deal with risk, cost and quality of executing acquisitions or sales of assets, as well as the quality of and ability to exercise ownership rights through the life of the investment.
- The ability of the local custodial system to provide adequate security and availability of the assets in which investors would invest is a key factor for foreign investors. These typically use the services of the major internal custodians, which engage a system of agent banks to provide final services. For example, in the past, foreign institutional investors often have utilized specialized subsidiaries located in Mauritius to access the Indian securities market and avoid particular taxes and investment costs.
- Other investment costs, such as stamp duties and cost of ownership registration, can make investments unattractive.
- Legal and regulatory frameworks should be consistently enforced. Countries that frequently change the rules of their legal interpretations impose direct and indirect transaction costs and may drive investments out of the country (e.g., ambiguous tax rules).

*Source: Zervos & Laderkal (2004).*

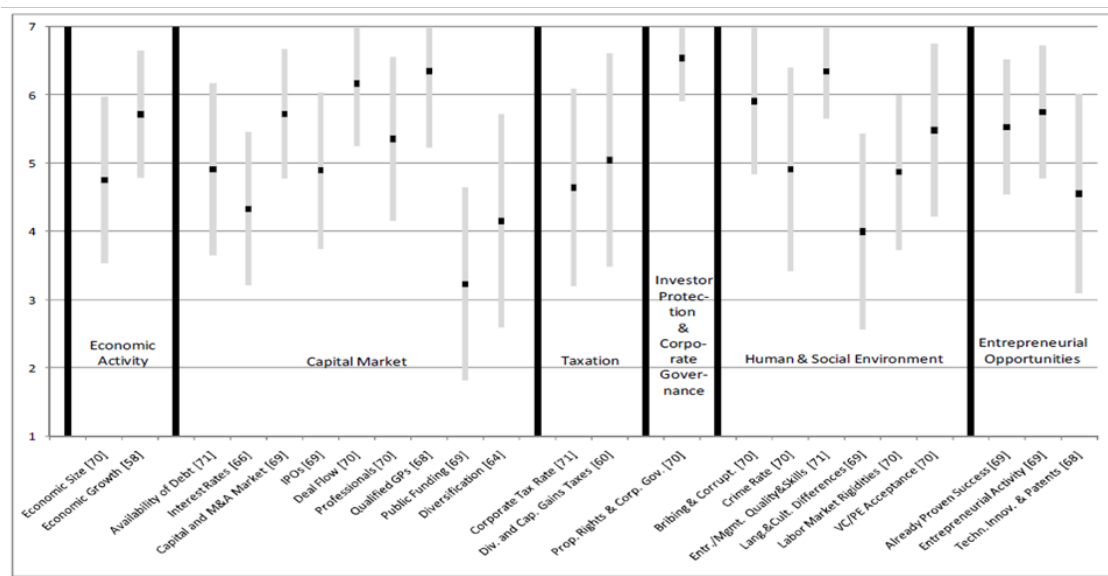
Because the large majority of impact investments are made through private debt or private equity, it is useful to consider various factors that are specific to these asset classes. A survey of 1,079 institutional investors<sup>4</sup> in private equity (limited partnerships) investigated the socioeconomic criteria that are most important when investing in developing and low-income countries. It found a number of factors that are particularly important for private equity investments (Groh, 2009). After considering the issues discussed in the literature, the study groups the factors according to six main drivers for private equity funding: economic activity, depth of capital market, taxation, investor protection and corporate governance, human and social environment, and entrepreneurial opportunities. Figure 5 illustrates their results.

<sup>4</sup> The study obtained responses from 75 investors, a response rate of 7 per cent, which is considered satisfying compared to most other studies that collect primary data on investor behaviour by means of a questionnaire.

Their findings indicate that economic activity and entrepreneurial opportunities are important drivers of investment flows, while taxation comes in a close second position. However, as the study points out, although these drivers are seen as the most important for investors in private equity, there are certain factors that act as barriers wherein investors will mostly refrain from investing if a country falls short of a satisfactory level of performance on factors such as adequate investor protection and corporate governance standards, sufficient entrepreneurial management skill and capital market activity. These latter three factors were ranked highest in importance for these investors, along with the presence of qualified general partners and the effects of bribing and corruption (Figure 5).

Although these survey results have myriad implications, a central takeaway is that subsidies (public funding) and privileged credit conditions are not, at least in themselves, sufficient to increase private equity funding from institutional investors. Rather, a variety of other socioeconomic factors can be targeted by policy initiatives to enhance the country's attractiveness to private equity institutional investors.

In turn, these enabling conditions can promote not only foreign investment, but a strong entrepreneurial culture and a productive innovation system that creates employment and economic growth and further enhances deal opportunities due to improved economic activity. Within this context, the importance of property rights protection and law enforcement structures is asserted (La Porta, Lopez-de-Silanes, Shleifer & Vishny, 1997; La Porta, Lopez-de-Silanes, Shleifer & Vishny, 1998), especially as it relates to issues such as corporate governance, corruption and bribery (Roe, 2006). In addition, a strong investment infrastructure and private equity ecosystem may be strengthened through targeted policy efforts that support the local capital market and encourages qualified general partners, deal flow, mergers and acquisitions, and other indicators.<sup>5</sup>



**FIGURE 5: NOMINATIONS OF IMPORTANCE OF CRITERIA WHEN INVESTING IN EMERGING MARKETS**

Source: Groh, 2009

<sup>5</sup> Also see the Global Venture Capital and Private Equity Country Attractiveness Index 2012 Annual, available at: <http://blog.iese.edu/vcpeindex>.

## 3.2 Impact Investment Policies

Around the world, there is an increasing trend of governments developing public-private partnerships, encouraging private sector investments and pursuing outcomes-based procurement and finance with social and environmental impact objectives. In an attempt to balance the need for fiscal consolidation and the demand for economic investments, job creation, near-term growth and economic stability, governments are increasingly supporting domestic impact investments, which can complement government services and attract private investment capital to assist in delivering social services (J.P.Morgan, 2011b). For example, in the United States, the government's USD\$2 billion Start-Up America initiative includes a USD\$1 billion impact investment fund that seeks to increase the economic impact of small businesses by funding entrepreneurs in underserved communities.

In addition, developed country governments have started to apply this philosophy to foreign aid strategies, where impact investments are increasingly being promoted for their potential to deliver developmental outcomes in developing and low-income countries of interest while demonstrating a level of budget control. Such programs have been developed by the U.S. Agency for International Development, the Overseas Private Investment Corporation (OPIC), the Office of the U.S. Secretary of State, and by the Department for International Development in the United Kingdom.

Similarly, developing and low-income countries that have challenging socioeconomic problems in addition to political and fiscal constraints may wish to support the development of the local impact investment industry. A host of targeted regulatory mechanisms and policy initiatives by these governments can attract foreign capital and outcomes-based financing to important impact sectors.

Based on a strong alignment between impact-first, financial-first, civil society and government interests, and with a view to attracting greater pension and sovereign wealth fund investment in the space, we consider the following government-sponsored initiatives.

### a. Strengthening the Pipeline

From deal sourcing, to co-investment, deal structuring and technical assistance, there are various ways in which greater government support can help build a stronger pipeline of investment-ready ventures and increase the supply of investment opportunities that meet the risk-adjusted return expectations of investors. Government programs can be put in place to achieve the following objectives.

1. **Technical assistance:** Programs can be put in place to provide technical assistance and advisory services to develop and strengthen the managerial capacity and track records of impact enterprises. By providing assistance at different stages of business development, such programs can help ensure the profitability and proof of business model concepts, and increase the supply of investment-ready ventures (Dalberg, 2012a). These programs include: training on business plan development, corporate governance, accounting, marketing, finance, raising capital and other critical areas of business management. Incubators and business centres can also serve as knowledge hubs where the support of lawyers, accountants and other professionals may be provided. A network of mentors, investors and potential clients can also be provided (Dahlberg, 2012a).
2. **Seed funding:** Early-stage funding can be provided or partly managed by the government. Such capital is needed to fill the gap between the stage at which private investors may be willing to invest and the financing needs of early-stage enterprises. This funding may be provided directly by the government on a competitive basis or by enhancing the role of development banks as a seed fund provider and technical support. Development

banks could play a strategic role providing: business planning, financial modelling, investment structuring and corporate finance advisory. Furthermore, governments can participate indirectly by putting in place incentives for angel and venture capital investors in the form of reduced tax liabilities and subsidies.

3. Entrepreneurship development: Other ways of encouraging impact entrepreneurship should be explored. Initiatives like business plan competitions, awards and prizes, awareness campaigns, public education, university and college courses and leveraging existing government programs— by including impact objectives in their agenda—can facilitate the goal of developing and creating more impact entrepreneurs (Dalberg, 2012a).
4. Networking: One of the most effective and cost-efficient ways of promoting knowledge sharing and capacity development among relevant actors is by encouraging the interaction of individuals representing diverse domains and knowledge systems within the structure of networking, industry and conferencing events. Such networking can connect policy experts and other actors from around the world and facilitate the production of new knowledge and tools to support governments. The Impact Investing Policy Collaborative is good example of the use of convening and knowledge brokering to enhance policy initiatives.
5. Apply successful business models: The experience of impact investors has highlighted a few prominent enterprise models that achieve both significant impact and attractive financial returns. As discussed previously, the IFC has outlined seven business models that have been particularly successful in its portfolio, while studies by the Monitor Group recommend seventeen successful models. These models (in terms of scalability, sustainability and impact) can be promoted in priority sectors by governments, which can assist in creating and analyzing the key success factors needed to replicate their success. With technical support, these models can be adapted to the local context, and may be implemented by new ventures or existing enterprises that may already have an established track record of business success in the sector.
6. Partner with capable organizations: Development finance institutions, foundations, impact networks and fund managers can bring complementary resources to the fore. Partnering with these organizations to develop and implement government programs can help ensure that initiatives developed are relevant to investors. Such partnerships can also serve as a bridge between local impact enterprises and foreign investors, which may benefit from lower deal sourcing and transaction costs by being part of this development process. For governments, the costs associated with program implementation may be reduced due to the resources that are provided by partner organizations.
7. Intermediaries and an impact investment ecosystem: To foster a robust impact investment ecosystem, it is necessary to build the capabilities of impact investment intermediaries and provide more incentives for existing financial intermediaries to get involved in the impact investment industry. The lack of syndicators, clearinghouses and other intermediate actors can make conducting deals more complex and costly for investors. It can also make it difficult for donors and governments that are building the investment readiness of enterprises to connect with market-rate investors who can provide the financing and the resources needed to take the enterprise to the next level (Dalberg, 2011). Moreover, many investors and fund managers rely on their personal networks to identify and source deals, while many entrepreneurs rely on their networks to find investors. Therefore, promoting local networks can also facilitate the impact ecosystem. Linking these to global networks like the GIIN and the Aspen Network of Development Entrepreneurs can help broker larger global divides.

## b. Promoting Blended Capital Arrangements

Blended capital arrangements allow governments, aid agencies, philanthropists and other impact-first investors to increase the power of their funds. By assuming a disproportionate level of risk relative to the capital they invest, they can make investment opportunities more attractive to other parties. One example is the use of government loan guarantees: in the event that the company defaults, the loan is guaranteed by a government agency that will purchase the debt from the private investor and take on responsibility for the loan.

Another is the use of structured credit, where the government will buy the junior notes in which a pre-agreed percentage of investment losses are absorbed by the government or the donor. The approach has been used in various sectors, including clean water, education, energy, agriculture, healthcare and microfinance. In these cases, a small amount of public or donor finance can attract a large amount of private investment capital by either reducing risks or raising expected returns. The resources provided by the government do not have to be financial but can also come in other forms, such as advisory services and technical assistance to companies.

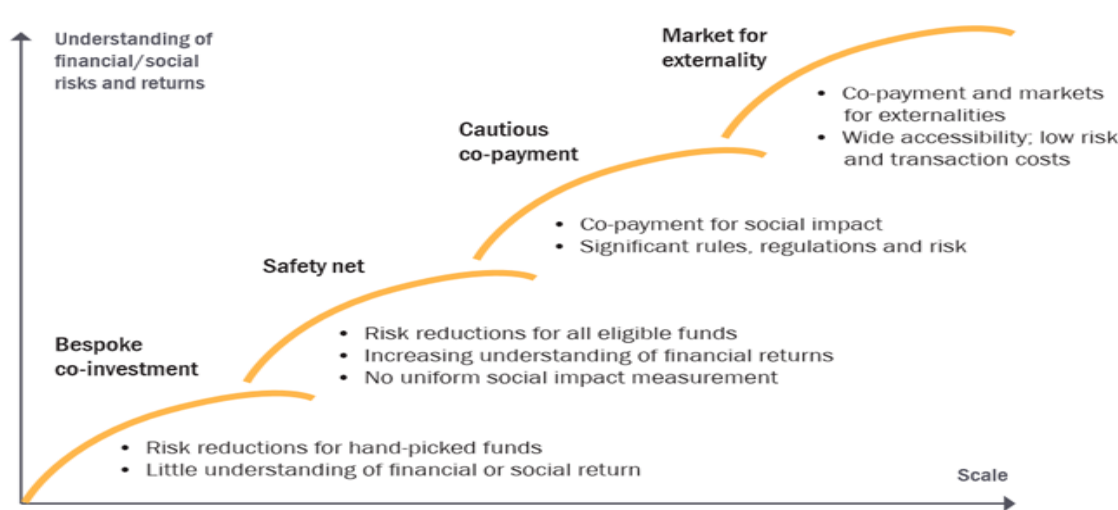
Funds with capital stacks may be created by structuring deals in a way that produces investment tranches that appeal to different parties, and other tranches that replicate market-rate return/risk profiles can appeal to mainstream investors. By being structured as such, the deals can leverage additional debt or equity capital from investors, and allow the participation of different parties that would otherwise not be possible. Further material about these funds with capital stacks will be covered in the innovative financing section.

Blended structures thus allow the government to leverage the impact objective against the profit-seeking objectives of financial-first investors with large amounts of capital. Complementary technical abilities can help scale-up impact enterprises to levels that would otherwise be impossible without combining the synergistic forces of these parties. Whereas private financing might not bring sufficient technical assistance, public or donor funding typically does not come with the same level of due diligence and flexibility that private finance brings.

Blended capital arrangements vary according to the various stages of investment and enterprise development, and investment types can include debt (enhanced interest rates, loan guarantees and risk insurance), private equity (dividend enhancement) and venture capital (start-up funding to reduce barriers to entry). A recent report by Dalberg associates outlines the following four prominent models (Dalberg, 2012b, pp. 28–31):

1. **Bespoke co-investment:** These customized solutions are provided by the government to limit investment risks and include credit guarantees and subordinated equity. They are used primarily in cases where governments want to encourage pioneering investments in areas where insufficient information exists to determine the risk/return profiles of investments. By limiting the downside to these investments, governments are effectively reducing information asymmetries. Investors are typically handpicked by the governments and terms are typically negotiated on a one-on-one basis between the parties. Therefore, transaction costs can be high.
2. **Safety net:** These are standardized tools that, like bespoke co-investments, reduce investment risks. They are differentiated from bespoke co-investments in that the offered risk-reduction is similar for all private investors, who then benefit from lower transaction costs. These include partial credit guarantees and minimum return guarantees. Such tools help bring a critical mass of funding where financing gaps may exist due to market failures such as the perceived lack of track record. For example, the model was successfully used in the microfinance space where blended capital was needed in the early stages to develop the sector, but, as it became more established, mainstream investors took interest and the need for guarantees disappeared.

3. **Cautious co-payment:** Instead of reducing risks, the government or donor will pay for the desired social outcome on a piecemeal basis by making a fixed payment for each unit of benefit that accrues due to the investor's or enterprise's activities. Therefore, the model is based on a promise of payment rather than a guarantee. It is an approach that is cost-efficient because governments do not have to tailor subsidy ex ante, so it works well if assessing the impact of an enterprise is easier after the investment has been made.
4. **Market for externality:** These mechanisms target widespread change by setting prices for social and environmental costs or benefits, which are often paid or collected by the government. The carbon tax is a well-known example of this approach. Another example is the subsidies given for school attendance by certain governments in developing countries. By targeting such widespread change, it lifts the tide for all impact enterprises in the sector.



**FIGURE 6: MODELS OF BLENDED STRUCTURES**

Source: Dalberg, 2012

The costs of implementing such structures, however, are significant. Like all financial structures, they require that financial returns, seniority, maturity and risk exposures be clearly specified from the beginning. These structures must also take into account the transaction costs involved, the sophistication of the market and the preferences of the parties.

### c. Consider Tax Policies and Subsidies

Enterprises that contribute to national impact objectives can be subject to preferred terms of business through preferred tax treatment or other forms of subsidies. Since impact enterprises typically face particular challenges and constraints compared to traditional enterprises, such measures can help provide the needed incentives or concessions to improve its chances of achieving superior financial results (Dalberg, 2012a). Once a government has identified its sectors and impact objectives of interest, it can use these criteria to determine which enterprises can benefit from such measures.

#### **d. Data and Impact Reporting**

Given the importance of impact metrics and measurements for investors, there may be opportunities for governments in developing and low-income countries to work with various impact sectors to determine which metrics may be of use and, subsequently, ensure that this information is being reported on by the enterprises in a way that meets investors' requirements. Governments can work with deal-sourcing platforms like the Aspen Network of Development Entrepreneurs, Toniic, GATEimpact and Mission Markets, local fund managers and investors, and standard-setting bodies like the Global Reporting Initiative and Impact Reporting and Investment Standards to develop these reporting guidelines and make sure that impact and financial data reach investors with a demand for such information.

#### **e. General Business and Investment Environment**

As discussed previously, the political and macroeconomic context of impact investments have a strong influence on the financial risks and returns that investors can expect, and therefore such factors have an important influence on their investment decisions. Although we emphasize the importance of government initiatives targeted directly at the impact industry, these efforts must also be matched with an adequate business and investment environment that fosters enterprise value creation, innovation, scalability and risk-taking, as well as promote impact objectives and the viability of the impact ecosystem.

#### **f. Consider the Fit of Existing Local Sovereign Wealth Funds and Pension Fund Mandates with National Impact Objectives**

In some cases, it may be possible to find alignment between national impact objectives and the mandates of local pension and sovereign wealth funds. Where alignment exists, it may be possible for these funds to make investments that generate specific social, environmental and economic benefits, along with the necessary financial returns. As such, pension and sovereign wealth funds can be harnessed to not only provide the required retirement income or other financial objectives, but also to contribute to the long-term well-being of beneficiaries, workers, retirees and their communities. Public and union-sponsored pension funds, as well as sovereign wealth funds such as state-owned investment funds, may be more inclined to this type of approach, depending on their legal and institutional context.

Such strategies have historically been used by union-sponsored pension funds in the United States to serve beneficiaries and their communities by targeting assets with the objective to expand employment opportunities in a particular geographical region, increase the availability of affordable housing, strengthen capital infrastructure, revitalize urban neighborhoods, help rural economies, develop SMEs or support green industries (Croft, 2009). Through ETI, these pension funds were able to provide more job security and encourage infrastructure projects and other investments that promote the public good. In fact, surveys have found that 18 of the 20 largest public pension funds in the United States have participated in ETIs, dedicating from 0.5 to 8.4 per cent of assets under management to these initiatives. Pension funds from around the world, especially those in the Netherlands, Denmark, the United Kingdom, Sweden, France, Canada and Australia, have historically used ETIs to achieve similar results. In low-income and developing countries, there exist several examples as well. In South Africa, similar strategies have been used by the Government Employee Pension Fund to support Black Economic Empowerment and channel more investments towards infrastructure in support of the government's economic transformation agenda.



Some sovereign wealth funds in Africa and the Middle East are targeting domestic assets with similar objectives in mind. A notable example was provided earlier in this report: the Mubadala Fund that is sponsored by the Abu Dhabi government is being used to finance the development of Masdar City, which is seen as a beacon for their green economy initiatives, in the hopes that it will support other strategic objectives, including job creation and economic growth. Newly created funds in Algeria and Nigeria have established their intentions to invest some of their assets domestically to generate social and economic development (Blankson, 2013; Rundell, 2012). In the United States, the New Mexico State Investment Council includes Economically Targeted Investments, which are intended to achieve market-rate returns while contributing to economic development.<sup>6</sup> Although sovereign wealth funds typically seek to achieve inter-temporal stabilization, diversification and maximize risk-adjusted investment return exclusively, a subset of these funds have historically been influenced by political factors such as the strategic economic interests of their governments. This influence often translates into financial support for local enterprises or subsidies for various industries within the country (World Economic Forum, 2011; Bernstein, Lerner & Schoar, 2009).

### 3.3 The Entrepreneurship, Inclusive Economy, Investment and Development Nexus

Impact enterprises exploit opportunities that are missed or underexploited by traditional business enterprises and the public sector. Rather than seeing the creation of social and environmental wealth as a by-product of economic value, impact enterprises seek to create social and environmental value as their primary objective, while the economic value they create is the result that enables them to be sustainable and self-sufficient in the long run. By creating and successfully applying novel business models to complex social, environmental or economic challenges, these enterprises are able to address the needs of society that would otherwise go unmet, all while producing a profit. It is said that impact enterprises are the result of personal and organizational traits that are shared by only a small percentage of the population, and marked by a determination to change society for the better by applying commercial ingenuity (Drayton, 2002).

These enterprises are gaining increasing importance in the context of inclusive economy and green growth policies in developing and low-income countries. Moreover, since the large majority of enterprises in these countries are MSMEs, encouraging social and environmental entrepreneurship can be a major driver of employment and economic growth. For example, approximately 97 per cent of enterprises in Mexico and Thailand fall into the small and micro categories, making these enterprises an integral component of sustainable economic development.

However, for impact entrepreneurship to kick-start sustainable inclusive growth, it must be matched by carefully designed government policies that attract private capital to these businesses. Impact investments in these enterprises are a necessary condition for scaling up the sector in these countries. Given that pension and sovereign wealth funds together represent a large portion of global assets under management, unlocking their investment capital can result in significant growth. Whereas these investors have a long-term horizon, they can be a quality source of patient capital.

<sup>6</sup> For a list of New Mexico's Economically Targeted Investments, see <http://www.nmlegis.gov/lcs/handouts/SIC%20Presentation%20to%20IOC%20July%202012--Summary%20of%20Economically%20Targeted%20Investments.pdf>

Research into the investment activities of sovereign wealth funds has found that sovereign wealth funds are already a major force reshaping the world economy and becoming major actors in the world of development finance (Santiso, 2008). Meanwhile, allocating only 10 per cent of their portfolio to emerging and developing countries over the next decade could generate yearly inflows in these countries that are larger than all Organization for Economic Co-operation and Development countries' development aid put together (Santiso, 2008). This capital inflow has wide ranging impacts, including the creation of jobs, providing capital for infrastructure and supplying long-term money for diverse industries. Since the large majority of these funds are domiciled in low-income and developing countries (only about 15 per cent are from Organization for Economic Co-operation and Development or developed countries), there may exist opportunities for aligning the greater financial motivations of these actors with potential development outcomes.

Pension funds, which are increasingly investing in emerging markets due to the attractive growth prospects that they offer, may also provide similar developmental benefits. Although these funds are mostly located in developed markets, their share of global assets under management is as much as 10 times larger than that of sovereign wealth funds, thus representing a sizeable amount of prospective funds as well.

## 4.0 *Innovative Financing for Impact Investing: Enabling Blended Capital Structures*

Impact investments are made in a range of different asset classes, financial instruments, market sectors, and types of projects with different social, environmental or economic impact purposes. The wide array of financial instruments in today's marketplace allows for the efficient flow of capital among the world's investors. Nevertheless, in the last decade, limited amounts of financial instruments have been used in the impact investment industry, this including: private equity (including venture capital), private debt (loans), deposits in community development financial institutions and, in some cases, public equity (stocks) and public debt (bonds).

When the impact investment industry was starting to develop more sophisticated financing structures, they allowed efficient risk distribution among investors, such as securitization technologies. When the financial crisis arose, it exposed a number of flaws, which led some to question whether asset-backed securities, a highly controversial financial instrument, should be a financial instrument that social entrepreneurs should be using to solve the world problems at scale. As a result of the turmoil of the financial crisis, the popularity of asset-backed securities decremented in the impact investment industry.

One of the key positive features of the securitization is that it allows an efficient risk allocation; nevertheless, during the financial crisis this feature represented a fundamental problem. This transfer of risk created an unexpectedly complex chain where all participants were still involved in the revenue stream of the financial product. The institution that initially granted the loans had already taken the risk off its balance sheet, giving them space to engage in reckless behaviour by continuing their lending activity and absorbing more market risk. All this risk-taking was intended to achieve a high return in the financial sector where the motto is to maximize shareholders wealth.

As securitization technology developed in the financial sector, the impact investment sector achieved an effective risk allocation with the same securitization technology. As explained in Box 6, the fundamental difference is that, in the impact investment sector, where the main purpose is the fair distribution of return and risk, the deals where successful and the delinquency rate of this structured product was close to zero.

Nowadays, as we have seen previously in this report, institutional investors, especially those seeking a market-rate return, have expressed concern over the lack of suitable investments that meet their criteria for a reasonable risk-adjusted return. Therefore, there is an evident need for innovative investment and financing options that are adapted to the needs of both the impact enterprises and investors. In the absence of these, much investment capital will remain on the sidelines, and the cost of capital for impact enterprises will remain correspondingly high.

Arguably, the return of the securitization technology in the impact investment sector could solve the barriers for institutional investors looking for specific risk-adjusted returns allocating the related risks to the most suitable participants achieving an optimal blended capital structure.

**BOX 6: SUCCESSFUL SECURITIZATION CASES IN THE IMPACT INVESTMENT INDUSTRY**

**European Investment Fund**

In 2005 the European Investment Fund, which is a financing company that is majority owned by the European Investment Bank and that focuses on lending to small and medium-sized enterprises, along with Swiss micro-finance consultants Symbiotic launched a €30 million collateralized loan obligation called the Micro-finance Loan Obligations. This instrument helped to raise funding for micro-finance institutions in the Balkans and Russia. The Micro-finance Loan Obligation was not rated, and the junior notes were purchased by specialist micro-finance investment funds such as the Swiss Investment Fund for Emerging Markets and Maryland-based MicroVest. The senior notes were guaranteed by the European Investment Fund and sold into the capital markets. The European Investment Fund and its partners estimate the deal led to the direct financing of at least 20,000 new micro-loans.

**Bangladesh Rural Advancement Committee securitization deal**

Established in 1972, the Bangladesh Rural Advancement Committee (BRAC) is one of the country's largest national non-governmental organizations. In July 2006 BRAC got into a USD\$180 million microcredit securitization deal for a term of six years. The deal was structured by RSA capital, Citigroup, the Netherlands Development Finance Company (FMO) and KfW Development Bank, and BRAC transferred the microcredit receivables into the Special Purpose Vehicle. One third of the securities so issued were purchased by the FMO, and another third by Citibank, along with a guarantee from the FMO. The remaining one third of the securities was purchased by Citibank N.A Bangladesh and two other Bangladeshi banks. The Credit Rating Agency of Bangladesh gave an AAA-rating to the certificates issued.

**IFMR and Equitas**

In India, IFMR Capital and Equitas Micro Finance India concluded the securitization of micro-loans in 2009. The underlying USD\$3 million loan pool consisted of urban micro-loans with maturity in 2010. The pass-through certificates were issued by a SPV in two classes: Class A1 and A2 with a rating of AA and BBB respectively. IFMR Capital, an Indian non-banking financial institution, bought all the Class A2 securities and Equitas provided protection against the first loss by providing a cash collateral of 11.7 per cent of the issue size.

*Source: Bothra, Kothari et al. (n.d.)*

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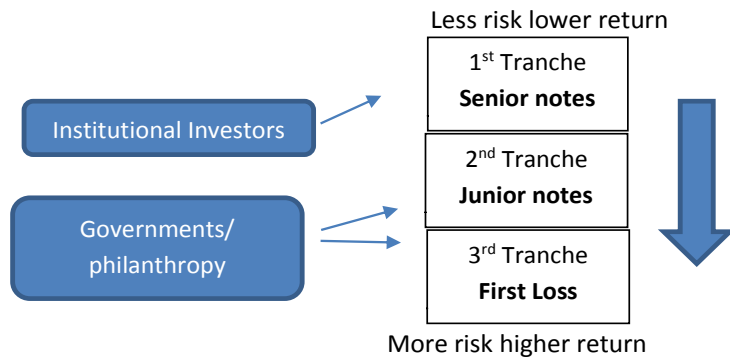
**4.1 Applying Securitization to Allow Blended Capital Financing Structures**

It is important that impact investments on commercial projects provide differentiated risk adjusted returns to appeal to various investor preferences and allow capital-stacking arrangements that favour the achievement of blended returns for the various impact-first and financial-first investors. These opportunities can be achieved with securitizations technology, which we describe below.

Securitization is the financial practice of pooling various types of contractual debt. The impact investment financing company (microfinance or any impact institution providing loans for social or/and environmental purposes) will pool

together loans and transfer them into a Special Purpose Vehicles (SPVs), which allow for the aggregation of these assets. These transfers of the loans out of the impact investment financing company gives it more space to continue its credit allocation activities to other impact investment deals. All weekly/monthly payments from the impact borrowers go to that SPV. Once these loans are pooled under the SPV, the financing company undertakes a process called “tranching,” which consist of designating different classes of risks. When the SPV receives the weekly payments, from all the loans that it holds, the first cash flows are allocated to the first tranche, then the second, the third and so on. Since the first tranche will always be the first one to get paid, the risk is significantly lower than the third tranche.

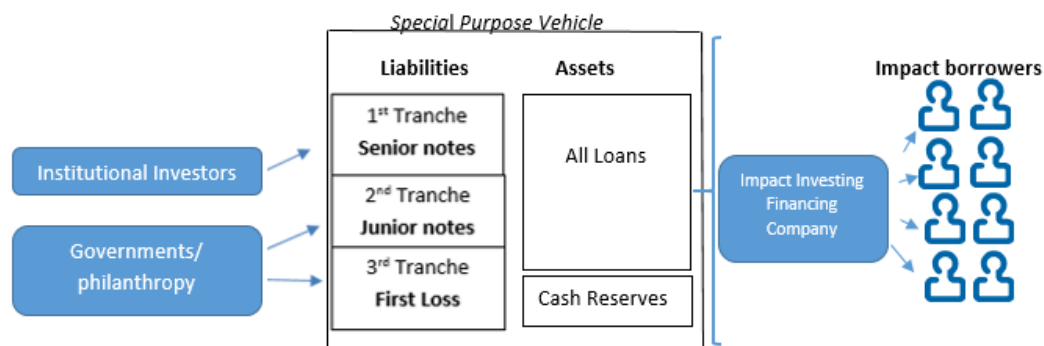
**Investor nature by risk/return**



**FIGURE 7: ALLOCATION OF TRANCHE ACCORDING TO THE RISK APPETITE OF THE INVESTORS**

With this technology, blended capital structures can be achieved successfully if governments, aid agencies, philanthropists and other impact-first investors agree to the first loss and junior notes from the issuance.

In the example of the Bangladesh Rural Advancement Committee securitization deal (Box 6), all the loans provided to the BoP sector were transferred into a SPV. After doing the tranching, a governmental Development Finance Company could buy all the junior notes absorbing the higher risks making the investment more attractive for the institutional investors who have to be compliant with their fiduciary duty. In the BRAC deal, the Netherlands DFC bought all the lower tranches and issued guarantees for the senior notes. Meaning that in the case of default, the government finance company will purchase the debt from the private investor and take on responsibility for the loan. With these guarantees, the securities achieved an AAA rating comparable to the safest bonds on the market.



**FIGURE 8: PROCESS OF SECURITIZATIONS BY USING A SPECIAL PURPOSE VEHICLE**

With the right policy development, securitization can work. But the question of whether it will actually work will depend on the risk management and quality of the underlying asset (loan) backing the structured product, as well as on the transparency of the transactions. Securitization technology has been applied successfully for the various institutions profiled in Box 6. Nonetheless, it is important to consider the following challenges involved in the securitization process.

## **4.1.2 Securitization Process Challenges**

### **4.1.2.1 Pricing the Structured Finance Instrument**

A “normal” structured finance instrument that is a fully liquid primary and in the secondary market is fairly easy to price by using electronic trading systems that match bid and offer prices or pick up the phone to brokers to collect some quotes. However, impact investment structured instruments are not traded in secondary markets and therefore prices for this asset class are unavailable; in such cases it does not make much sense to price an instrument at using “market to market” methodology if the market is inexistent on the first place. The “mark to model” can be used to price these instruments, but only under fairly normal market conditions as these pricing models are usually based on functioning markets.

### **4.1.2.2 Collection Performances**

Most MFIs have reported strong collection performances so far, thus proving the features of securitization. These strong collection results are attributed to the product characteristics; for example, most MFIs lend through the joint liability group model, which requires borrower groups to take repayment pledges that state that if one group member defaults, other members make up for the default.

Nevertheless, loans to other sectors of the impact investment industry face bigger challenges under the collection performances. The credit history from BoP entrepreneurs could not be reliable, which could pose considerable complexity for the risk management of the asset back securities.

### **4.1.2.3 Information System-Related Risks**

Securitization is a data-intensive technology. To achieve the appropriate sizing of credit enhancement, originators need to provide detailed information on portfolio and static pools. Moreover, surveillance requires the financing company to furnish detailed performance reports on the rated pools. Most financing companies in the impact investment industry are small and are still in the process of developing systems that are capable of generating timely management information reports required for securitization transactions. The management of this information to accurately monitor the risk of these structured products could increase the operation cost of the impact financing company, translating this excess cost to the impact borrower.

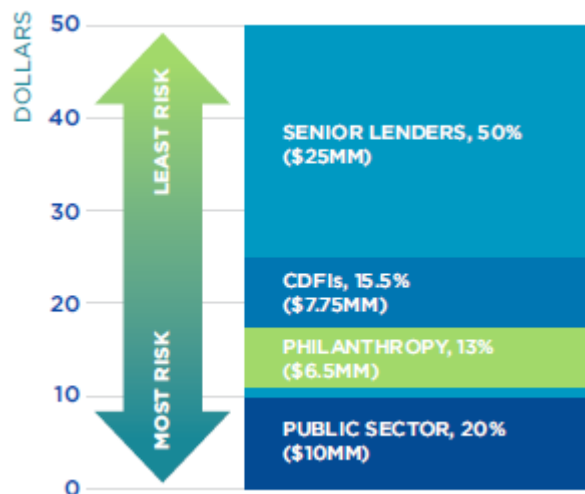
### **4.1.2.4 Tax Issues for SPVs**

Servicing costs for loans on the BoP sector are much higher than for traditionally securitized assets. If such servicing costs become subject to value-added taxes, the transaction economics may be materially affected. In the India context,

securitization transactions basically operate on the premise that typically a trust will offer the income earned from the investment to tax to the beneficiaries of the SPV, and thus the income should not be taxed at the level of the trust. In the 2013 Union Budget (PWC, 2013), the Indian Securitization Foundation, which represents India’s securitization industry—comprising banks, non-banking finance companies, micro finance institutions, and other stakeholders—has sought a pass-through status for securitization vehicles, whereas Budget 2013 imposed a distribution tax of 25 to 30 per cent on distribution of incomes by the securitization vehicles starting June 1, 2013. This change will have an effect on the Indian securitization market. Most market participants are of the view that the most immediate and severe obstacle to securitization is this unresolved issue of taxation of the securitization SPV.

## 4.2 Alternative Funds

Securitization remains a controversial topic on the social finance sector. Private Investment Companies entering impact investing are approaching the sector with sophisticated solutions for achieving blended capital arrangements through alternative investment funds, leaving the securitization technology aside. The argument is that the blended capital structure of this alternative fund is more transparent and less complex than the one achieved through a securitization process. These alternative funds are similar to securitization in the sense that they achieve an effective risk allocation. In the first example, they achieve it by tranching the liabilities, while in the alternative fund they make layers of the capital. These two methods have similarities in that the first revenue stream entering to the fund is allocated to the senior equity holder and the last ones to receive revenue streams are the lowest tranches of the equity. This method of layering the capital structures the fund in various investment tranches that appeal to different parties. Each layer reflects a different risk/return profile. The investors buying seniority equity (the top layer) get priority for repayment. If the fund experiences some losses, the junior equity at the bottom will be less likely receive repayment in full.

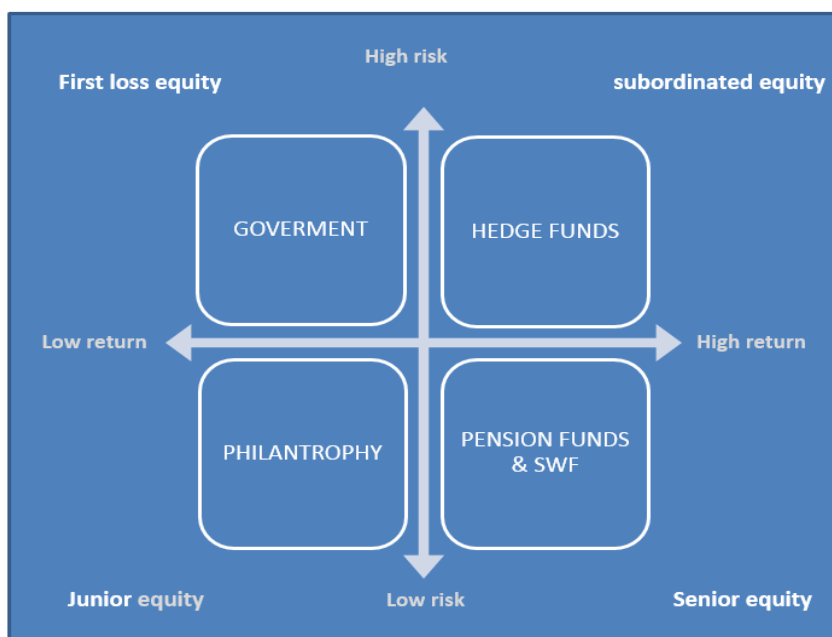


**FIGURE 9: ALTERNATIVE FUNDS CAPITALIZATION STRUCTURE EXAMPLE**

Source: *Living Cities*, 2013

For example, a fund with high risk investment strategies can very rarely attract institutional investors. A fund entering into new impact investing themes such as housing, energy and agribusiness with unproven business models where risk are high can very rarely receive capital from pension fund investments.

In this alternative fund capitalization structure, which allocates the risk efficiently, impact investments could be scaled-up by attracting institutional investors to buy the top senior layers. For this type of fund, the public sector plays a crucial role. If government financing institutions or development banks buy these subordinated securities (low-return/high-risk equity), it can incentivize the private sector to invest in the senior layers of these alternative funds. The risk for institutional investors will be low even if the impact investment is high in risk. If the alternative fund loses value, the first one to absorb that loss will be the lower layers. With the public sector absorbing those junior layers, institutional investors enjoy a buffer in the event that the fund loses money.



**FIGURE 10: INVESTORS' MATRIX ACCORDING TO RISK RETURN PROFILES**

These alternative fund structures are being used in various sectors of the impact investment industry, including clean water, education, energy, agriculture, healthcare and microfinance. With this innovation, a small amount of public or donor capital can attract a large amount of private capital by reducing risks and raising expected returns for any given project.

### 4.3 Social Impact Bonds

In recent years the impact investment industry has begun to develop and employ more sophisticated fixed income financial instruments. One prominent example is the promotion of social impact bonds. In September 2010, a United Kingdom-based institution called Social Finance launched the world's first Social Impact Bond (SIB).<sup>7</sup> SIBs are

<sup>7</sup> For more information on the Social Impact Bonds, see: <http://www.socialfinance.org.uk/social-impact-vct>

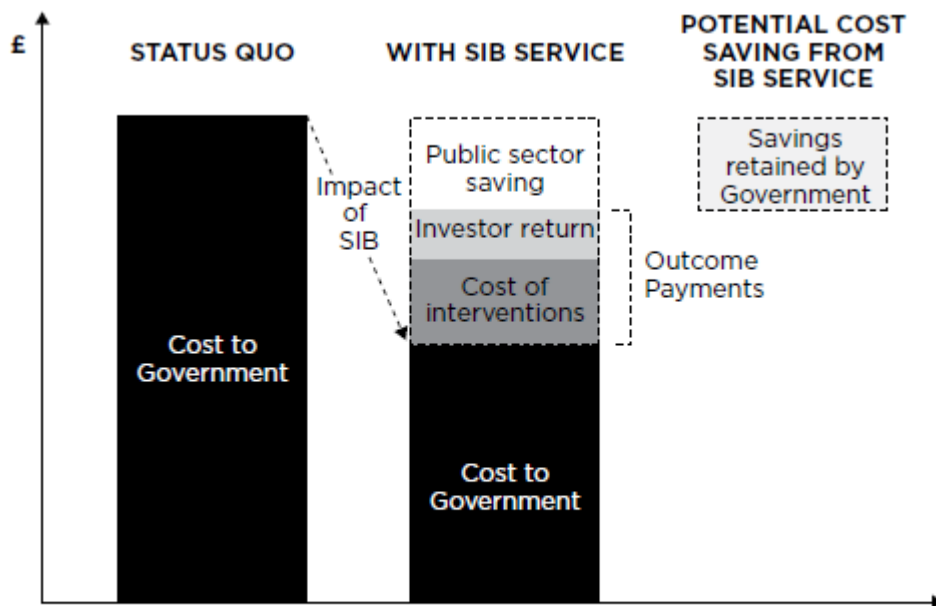


outcome-based contracts in which the public sector commits to pay for significant improvement in social outcomes (such as a reduction in offending rates or in the number of people being admitted to hospital) for a defined population. These types of bonds are an innovative way of attracting new investments around such outcomes-based contracts that benefit individuals and communities. Through an SIB, private investment is used to pay for interventions that are delivered by service providers with a proven track record. Financial returns to investors are made by the public sector on the basis of improved social outcomes. If outcomes do not improve, then investors do not recover their investment.

The first SIB was launched in September 2010 at Peterborough Prison. It funds rehabilitation services for short-sentence prisoners released from the prison, with the express aim of reducing reoffending post-release. If the institution achieves a lower reoffending post release rate, then the bond will pay according to what the government is saving with this rate reduction of criminals in the prison.

SIBs focus on funding preventative and early intervention programs that tackle the underlying causes of specific social problems. The aim for these interventions is to achieve cost savings for the public sector. The issuer estimates the costs of interventions, overheads and other fixed costs, which together determine the level of investment requirement over the life of the SIB. If there is a cost reduction achieved for the government this will be the share of the revenue agreed to be distributed to investors if a sufficient improvement in outcomes be achieved.

This value-for-money calculation can be summarized as follows:



**FIGURE 11: SIB STRUCTURE**

Source: Social finance

SIBs align public-sector funding more directly with improved social outcomes and they increase the pool of capital available to fund prevention and early interventions. By doing so, they encourage a more rigorous approach to performance management, including the objective measurement of outcomes that contribute to building a broader evidence base for what works.

## 5.0 *Building the Impact Investment Ecosystem: Best Practices in Implementing Enterprise-Based Development in India*

While government support and financial innovations are necessary to expand the set of profitable impact investments, they are insufficient, in themselves, for achieving enterprise-based development. Enterprise-based development requires the advancement of a robust and efficient entrepreneurial ecosystem that can encourage entrepreneurs and incumbent firms to seek out and deliver the impact objectives of governments, foundations, development finance institutions and other impact-seeking organizations through the implementation of innovative business models, all while achieving the financial return expectations of market-rate investors in the long run.

In this case study on India, we highlight the pioneering activities of the government and the financial industry in building the domestic entrepreneurial ecosystem to enable enterprise-based development in the country. Although, more progress is still to be made in building this ecosystem to expand the impact investment pipeline so that it can support greater institutional investment into India's impact sector, the promising activities of firms like Aavishkaar, Intellegrow Finance and the Intellegrow Impact Investing Network demonstrate that ecosystem-building activities can bear fruit and progressively unlock the needed institutional capital that had thus far been sitting on the sidelines. An effective impact investment ecosystem therefore will build the pipeline of investment-ready ventures and thus expand the pool of viable investments for institutional market-rate investors seeking a reasonable return.

The ecosystem-building activities, which we profile below, fall into the following categories:

1. **Aavishkaar Group of Funds (Aavishkaar):** Aavishkaar is the pioneering impact venture fund management company. Established in 2001, Aavishkaar uses a “hands-on entrepreneur-focused” approach that allows it to nurture its portfolio companies into profitable, scalable and sustainable impact enterprises by providing early-stage support, strategic advice, networking and enhancing access to further capital from other investors. Because of the nascence of the entrepreneurial ecosystem in India when it was set up, Aavishkaar's investing model is based on the belief that it would have to nurture the ecosystem while nurturing the investee companies. Therefore, it employs a patient, long-term approach to financing and focuses on accepting disproportionate risks to build new companies in difficult geographies (the underserved, rural areas of India). Aavishkaar's ability to build the impact ecosystem and the various networks that compose it has a lot to do with the tireless work by its affiliates like Intellegrow and partner organizations such as Villgro, which allowed Aavishkaar to develop the entrepreneurial ecosystem and prove a reasonable level of investment success at a low cost, as evidenced by its historical investment performance.
2. **Intellegrow Finance (Intellegrow):** Intellegrow was created in response to a systemic lack of debt financing and skills support for small businesses in India. Initially conceived in 2010, it is India's pioneering provider of debt finance for unbanked but viable enterprises. In contrast to the collateral-based lending approach most often used by other lenders, Intellegrow employs a viability-based approach to lending, providing commercial yet affordable customized loans to enterprises that can demonstrate a clear future income stream to repay these loans. Whereas a large number of early-stage enterprises have historically been underserved through collateral-based lending, Intellegrow's approach has the potential to address the financing needs of a significant subset of Indian enterprises. Intellegrow's close relationship with Intellegrow—its parent company—allows it to provide a wide range of services to investee companies, including advisory services, mentoring, investment banking and other modes of business support.

3. Intelicap Impact Investing Network (I<sup>3</sup>N): I<sup>3</sup>N was created by Intelicap in 2011 to unlock domestic angel investment to address the pre-venture-capital funding gap that existed in India for impact enterprises. I<sup>3</sup>N raised USD\$100 million to invest in early-stage impact enterprises in need of equity capital in the range of USD\$100,000 to USD \$1 million to adjust for the fact that very few investors in India were willing to assume the large business model and execution risks that came with such investments. The angel network also helps provide managerial expertise to investee companies. I<sup>3</sup>N is also seeking to raise a separate USD\$15–20 million fund that would seek to make “catalytic” investments targeted specifically to allow greater investments from institutional investors, by developing the investment profile of these companies to meet the requirements of institutional investors.
4. Government initiatives: The Indian government has helped advance enterprise-based development since the 1970s by promoting investments in priority sectors like agriculture, small enterprises, retail trade, education, housing finance and underserved areas for inclusive economic growth, through various financial sector policies and programs. In 2010, the president of India declared the coming decade the “Decade of Innovation” wherein innovation, entrepreneurship and impact investing are promoted for their contribution to enterprise-based development and inclusive economic growth. As part of this plan, the National Innovation Council was created to implement the government’s vision and administer various programs, including an Inclusive Innovation Fund, which will invest directly in social enterprises. Also part of these programs is the establishment of thousands of Cluster Innovation Centres throughout India to connect various ecosystem players in industry, research and development, and government programs in financial institutions with emerging impact enterprises.

After describing the contributions of these four impact investment players in more detail, we will take a systems view of India’s impact ecosystem by making linkages between the activities of these industry players and describing how their efforts combine to strengthen the entrepreneurial ecosystem. We make some preliminary observations with regards to how other measures by the government and the financial industry may lend further support to their ecosystem-building efforts.

This section is based on a series of interviews with pioneers in India’s impact investment industry. Five senior executives representing Aavishkaar, IntelteGrow Finance and the I<sup>3</sup>N were interviewed using a semi-structured approach.

## 5.1 India Context and Government Initiatives

India has been a hotspot for impact investment since the outset of current-day microfinance. First introduced in the 1970s by pioneers such as Muhammad Yunus and Akhtar Hameed Khan, their goal was to help poor people escape poverty by providing them with better access to loans and other financial services that would allow them to generate self-income and manage their assets in a more financially efficient manner.

Since the 1970s, the Indian government has put policies and programs in place to facilitate the growth of the impact industry in priority sectors, requiring that all public and private banks direct a fixed percentage of lending to sectors it defines as underserved or priority areas for economic growth. Priority sectors include agriculture, small enterprises, retail trade, education and housing finance. These requirements by the Reserve Bank of India have, throughout the years, driven significant funding to microfinance institutions, and, today, require that domestic banks make 40 per cent of all loans to these priority sectors, while foreign banks have a minimum requirement of 32 per cent (Insight at Pacific Community Ventures & The Initiative for Responsible Investment at Harvard University, 2011). Since 1998, the Reserve

Bank of India requires that 20 per cent of priority sector lending go to “weaker section” small business and agricultural borrowers. The policy aims to ensure that resources are channelled into national priority areas, while fostering the inclusion of the poor in India’s economic growth.

Another important mechanism has been the Small Industries Development Bank of India (SIDBI), which is a financial institution that was put in place by an act of Indian Parliament in 1990 to aid the growth and development of MSME in India. The institution enhances the access to financial services for these enterprises by offering direct credit, providing guarantees to banks for collateral-free loans provided to MSMEs, and providing venture capital to these MSMEs. Its main sectors of interest include small-scale industrial units, rural enterprises, energy projects, financial services, health care and transportation (United Nations Global Compact, 2012). The SIDBI aims to develop sustainable and scalable companies, including those that engage the BoP, and to contribute to inclusive growth. The SIDBI also offers training and education programs for entrepreneurs.

In 2010 the president of India declared the start of the “Decade of Innovation” with a specific focus on addressing issues of poverty, and created the National Innovation Council (NInC) to develop and implement a “National Roadmap for Innovation” over the decade. NInC’s vision, which was driven by Sam Pitroda, an Indian entrepreneur behind the Indian telecom revolution, is to reorganize the innovation system of India from an “ad hoc” model, to one that is based on strategically integrating sustainability, durability, affordability, quality, global competitiveness and local needs (World Economic Forum, 2013). Thus, NInC seeks to build structures and policies to enable the government to identify, organize, support and scale these innovations. The NInC was put in place as the central hub for administering the government’s implementation of these functions. Thus, it is hoped that India’s entrepreneurial ecosystem will be built.

The components of this plan include: the establishment of Cluster Innovation Centers throughout India to connect industry activities, research and development, government programs and financing institutions to each other in a systematic manner; the creation of an Inclusive Innovation Fund, which is an early-stage venture fund to invest directly in social enterprises that generate a modest financial return alongside measurable impact; and other initiatives, including the Global Innovation Roundtable, which will organize events to spur collaboration between policy-makers and experts across geographies. Since 2011, the program is estimated to have involved 85,000 MSMEs, leveraged 39 public-private partnerships, created 1 million jobs and generated over USD\$4 billion in business revenue in poor communities (World Economic Forum, 2013). Thus, NInC is seen as a positive agent for catalyzing long-term change in the national entrepreneurial culture and in developing the national entrepreneurial and impact investing ecosystem.

Thus, innovation, entrepreneurship and impact investing are being promoted as part of an enterprise-based development approach. Entrepreneurship is seen as innovation-driven to “help to generate solutions to India’s myriad social problems including high-quality education, affordable health care, clean energy and waste management, and financial inclusion” (Government of India Planning Commission, 2012, p. 3). Seen by the government as “an imperative in India,” it is estimated that about INR400 crore (USD\$80 million) of impact investments were made in 2011 (Government of India Planning Commission, 2012). Whereas it is estimated that INR3 lakh crore (USD\$55 billion) would be needed over the next decade to fund entrepreneurship growth by way of investments, it is thought that “a significant part of this would need to be impact investing to address some of India’s key development issues such as sanitation, clean drinking water, affordable healthcare and clean technology” (Government of India Planning Commission, 2012, p. 15).

However, despite the supportive policies and programs and an explicit orientation towards enterprise-based development in India, research by the Government of India’s Planning Commission has shown that there still exist key systemic barriers and scale-up challenges for start-ups in India. Therefore, other measures are needed to enhance the following drivers of a vibrant entrepreneurial ecosystem, including (Government of India Planning Commission, 2012):

- Catalytic government policy and regulations in terms of: facilitating investments, enhancing and scaling up venture incubation programs, lowering the regulatory and administrative burden on entrepreneurial activities, making it easier for investors to exit investments and establishing expeditious procedures for closing businesses.
- Improving access to capital in terms of: removing regulatory hurdles currently inhibiting domestic fundraising, providing government-sponsored funds to seed early stage ventures, and developing and scaling up debt offerings to meet the working capital requirements of enterprises.
- Promoting businesses as entrepreneurial hubs by: engaging the private sector in setting up and operating incubators in public-private partnerships, and promoting the role of industry bodies and chambers of commerce in driving greater collaboration between enterprises and investors.
- Fostering a culture and institutions that encourage entrepreneurship over careerism through: upgraded courses and programs, enhanced linkages between educational institutions and the entrepreneurial ecosystem, promoting the commercialization of innovations, and celebrating and showcasing entrepreneurial success stories.
- Developing adequate and effective collaboration forums through the creation of dedicated online portals, encouraging the creation of collaborative forums and setting-up the Innovation Labs throughout India that could serve as a hub for incubators, accelerators and other enablers on a more local level.

In the absence of such measures, India currently ranks 132 out of 183 in the ease of doing business (World Bank, 2012), places very low on entrepreneurship with a rank of 74 among 79 countries, and ranks 62 out of 125 countries on innovation (Global Entrepreneurship and Development Index, 2012). As an illustration of this problem, consider that about 500 companies are incubated in India annually, compared to 8,000 annually in China; furthermore, less than 150 start-ups are promoted by venture capital or angel investors annually in India, compared to 6,000 angel investments alone in the United States (Government of India Planning Commission, 2012). This standing, however, is not limited to India alone, but is rather a common situation for many low-income and developing countries. Therefore, ecosystem-building activities by the government and the financial industry are critical in this context.

## 5.2 Aavishkaar Group of Funds

Aavishkaar is India’s pioneering impact venture fund management company. Established in 2001, its founders recognized an opportunity for a venture capital firm that would cater specifically to early-stage enterprises designed to create social and environmental impact in addition to competitive financial returns. Specifically, they recognized that, whereas some of most successful venture capital ecosystems around the world were built on the basis of intellectual-property-driven entrepreneurial growth—such as in Silicon Valley and Israel, which are specifically oriented toward information technology ventures—the Indian impact investing landscape would be driven by business model innovation in terms of how businesses adapt their approach to be able to cater to lower-income segments and deliver world-class products and services at a low-cost or frugal innovations. They identified agriculture, dairy, education,

energy, handicrafts, health, water and sanitation, technology for development, microfinance, and financial inclusion as sectors that showed the most promise for entrepreneurial growth. By focusing on early-stage, high-risk businesses operating in rural and underserved geographies (representing a market of 700 million people), they developed an investment strategy called an “enterprise-based development approach” that is founded on the belief that “taking disproportionate risk by investing in early stage businesses that gainfully engage rural and underserved populations either as customers, owners or in their supply chain, can not only deliver near commercial returns, but also bring about significant developmental returns that are proprietary in nature as the investments create the enterprises that make impact” (Vineet Rai, Aavishkaar, Personal Communication, May 9, 2013).

In carrying out this strategy, Aavishkaar relies on a strong on-ground presence that allows it to nurture its portfolio companies into profitable, scalable and sustainable enterprises that are able to attract further capital from other mainstream and social investors, accelerate revenues and provide exit opportunities. Thereby, Aavishkaar seeks to become an investee company’s “partner in progress,” working with them shoulder to shoulder without taking managerial responsibilities. Some of the key roles that Aavishkaar manages to take on more effectively include: defining the strategic direction of a business and acting as the second eye on the execution of the strategy, defining and building the fundraising strategy and executing it, assisting in rebuilding the governance structure and building the media strategy and other managerial activities, in addition to providing capital (Vineet Rai, Aavishkaar, Personal Communication, May 9, 2013).

Because it invests in enterprises operating in rural and underpenetrated markets, and with longer time horizons for its investment, Aavishkaar takes significantly greater risks than its mainstream counterparts. However, Aavishkaar seeks to adequately manage this risk by way of its hands-on approach and through sufficient diligence based on scouting entrepreneurs with strong business acumen and deep sector knowledge and experience, while gauging businesses by their commercial focus and viability and their ability to grow in scale and operational efficiency. One of the key risks to mitigate in Aavishkaar’s high-risk investing strategy has been its steadfast focus on investing in companies that focus on solving the “need-based demand” of the low income customer.

Although it took Aavishkaar five years to raise its first USD\$1 million, thereafter it went on to close two funds: Aavishkaar I, a micro-equity fund that closed at USD\$14.3 million with investments in 23 companies, and Aavishkaar Goodwill I, a micro-finance fund that closed at USD\$18.3 million with investments in 7 companies. With years still remaining in their fund life, these two funds have already achieved five profitable exits, and have also attracted 17 follow-on investment rounds of a combined value of over USD\$125 million from mainstream and impact investors (Vineet Rai, Aavishkaar, Personal Communication, May 9, 2013).

Seeking to build upon the initial success of these funds, Aavishkaar II and Aavishkaar Goodwill II, were created. These latter funds build on the experience and track record of their predecessors, allowing Aavishkaar to refine its investment philosophy to incorporate a greater focus on scalable businesses, and on the ability of entrepreneurs to scale and build the business. Aavishkaar sought enterprises that demonstrated a clearly defined investment-demonstration-progress linkage and clear capital needs and opportunities for further growth. Aavishkaar Goodwill II and Aavishkaar II closed in late 2012 and early 2013 respectively. Aavishkaar Goodwill II closed at US\$33 million, while Aavishkaar II closed at USD\$93.8 million and has a term of approximately 10 years, with a 20 per cent target internal rate of return net of fees and a 8 per cent hurdle rate, while exit routes are expected to use a combination of third party sales, acquisitions and IPOs.

**BOX 7: AAVISHKAAR GROUP OF FUNDS**

**Aavishkaar India Micro Venture Capital Fund (Aavishkaar I)**

Aavishkaar I was created in 2002 to promote inclusive development in rural and semi-urban regions in India. The fund's mission was based on the premise that promising MSMEs will help drive positive changes in underserved regions of the country. This fund enabled Aavishkaar to demonstrate that the venture capital approach to achieve dual returns works. Not only has the fund seen exits, but a number of portfolio companies have gone on to become some of India's most spoken about and innovative companies, scaled up and raised multiple rounds of capital since.

**Aavishkaar Goodwill India Microfinance Development Company - I (Aavishkaar Goodwill I)**

Aavishkaar Goodwill I was incorporated in Mauritius in December 2006 and achieved its final closing in May 2008. Aavishkaar Goodwill I provides equity capital and active support to microfinance start-ups and MFIs that are in the transformation or growth stage. The objective of Aavishkaar Goodwill I is to maximize value by focusing on scalability, efficiency and leverage, and by applying a rigorous private equity approach within a mission-driven setting. The fund is fully deployed in seven MFIs across India, and has already achieved two partial exits.

**Aavishkaar India II Company Private Limited**

Aavishkaar II aims to build on the experience and track record of its predecessor, the Aavishkaar I fund and will make equity investments in enterprises offering products and services in areas such as healthcare, water and sanitation, education, renewable energy and agriculture, with a significant proportion of these investments being in low-income states. Aavishkaar II is founded on the principal belief that entrepreneurial initiatives in underserved areas can not only create commercial returns for investors, but also bring about significant efficiencies and development in these areas.

**Aavishkaar Goodwill India Microfinance Development Company - II (Aavishkaar Goodwill II)**

Aavishkaar Goodwill II is the follow-on fund of Aavishkaar Goodwill I and was also established with the aim of investing in enterprises active in the microfinance sector on a socially and commercially sustainable basis. Aavishkaar Goodwill II is currently actively investing with a broader mandate of financial inclusion and exploring opportunities in sectors such as micro-insurance, micro-pension, banking correspondent models and financial technology, in addition to vanilla microfinance.

Aavishkaar has managed to do early-stage impact investing at a commercial price of 2-2.5 per cent in management fees and a total cost ratio that is considered extremely challenging to achieve for much larger funds for similar investment activities. It is one of the most cost-efficient funds globally, especially considering the travelling distances posed by rural markets and larger teams. It has been able to establish such a comparative advantage by managing and building a pipeline of funds and building a team that understands the need to stay frugal at the fund level, as it expects its companies to role out frugal investment models as well. Aavishkaar has also benefitted hugely from investing in the entrepreneurial ecosystem with its affiliates and partners, which allows prospective investee enterprises to emerge regularly, making Aavishkaar more effective.

Aavishkaar has also developed an efficient system that allows them to fund these companies, provide management support, take them to a stage where other investors can participate and finally look to an exit by selling to a secondary investor or a strategic buyer. On an ecosystem level, Aavishkaar has built a proprietary pipeline of start-ups that are scouted through references from other entrepreneurs, its long-term partnerships with incubators and its on-the-ground presence with various partners over the last 12 years. The collaborative approach that Aavishkaar uses with investee companies and other players in India's impact investment ecosystem allows it to efficiently use an active, needs-

based hand-holding method on diverse dimensions including fundraising, strategic advice, networking and early-stage support, at low cost.

Through the years, Aavishkaar estimates that its investee companies have directly benefited 9.7 million people and created over 20,000 jobs, with an estimated 75 per cent of beneficiaries being women. The following are highlights illustrating the social and environmental impacts of these companies from April 2012 to March 2013 (Vineet Rai, Aavishkaar, Personal Communication, May 9, 2013):

- 1 million dairy farmers witnessed an increase in income from transparent and efficient milk collection processes.
- 1.2 million people benefitted from accessing contamination-free potable drinking water through water purification systems.
- 4.6 million people, of whom 90 per cent were women, accessed financial services through investee MFIs.
- 517,000 students enhanced their understanding of science and English from exposure to Butterfly Fields and Karadi Path's products and training in schools.
- 568,000 women saved cooking fuel costs by using Servals' energy efficient stove burners, which also led to the reduction of 126 thousand metric tonnes of carbon dioxide emissions.

### 5.3 Intellegrow: Impact Investment Venture Debt Model

Intellegrow is India's innovative provider of debt finance and skills support to small and growing impact enterprises in India. It was founded by Intellecip and Shell Foundation in 2010 following the success of Intellecip's venture into new models for lending to this emerging segment of the Indian enterprise ecosystem. Intellecip is a pioneer in the provision of innovative business solutions that help build and scale profitable enterprises that are dedicated to social and environmental change. It provides investment banking, consulting to policy-makers and development finance institutions, and research services.

With support from Shell Foundation, Intellegrow was developed and incubated initially as a pilot within Intellegrow—a subsidiary of Intellecip—to test a new model of lending to small and growing businesses. Rather than approach small business lending the way most financial institutions did (by focusing first on collateral and an audited track record of profitability as a basis to lend), Intellegrow adopted a fundamentally different approach: viability-based lending. By focusing first on the quality of the management team and business model, and identifying specific activities of a business that directly generate cash flow to repay a loan, Intellegrow was able to mitigate its risk while directly contributing to the managed growth of its borrowers. During this initial pilot period, Intellegrow lent to some of India's leading early stage enterprises, including Vortex Engineering, Husk Power Systems and Global Easy Water Products, among others. Based on a clear demand for its services, Intellegrow then spun off as an independent non-banking financial company in 2012. Although many organizations and investors were providing equity, prior to Intellegrow's founding, there was a shortage of routes for small and growing enterprises to access debt financing. Therefore, an important market need that Intellegrow was seeking to meet was the lack of venture debt solutions for early-stage impact enterprises in India.

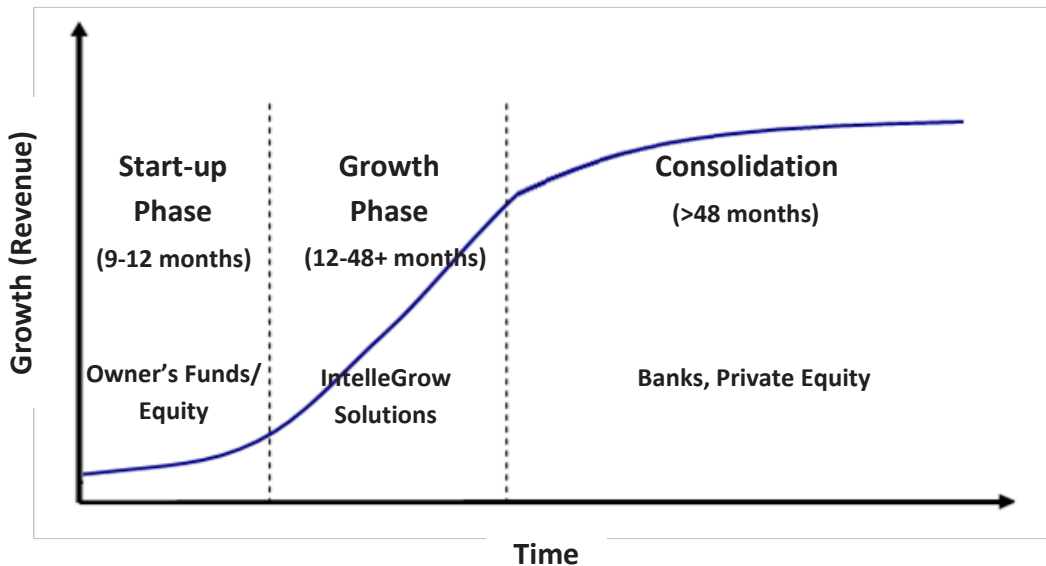
Before Intellegrow's arrival, small and growing enterprises had to resort to using limited and expensive equity financing to meet their debt financing requirements—a painfully inefficient and insufficient solution. More often, where equity investors were not present, businesses were forced to grow organically through internal revenue at a stunted rate, or attempt to raise funding from banks or other financial institutions. This was a slow and typically fruitless process



due to the banks' requirement of three years of consecutive profitability and audited financials, and other lenders frequently asking for similar restrictive conditions. Where a lender was willing to provide financing, the time from first application to disbursement was often prohibitively slow. Options for these enterprises were cumbersome due the fact that most formal lenders used a traditional collateral-based lending approach and required at least three consecutive years of profitable, audited track record. Other financial institutions capable of lending to small businesses were often slow and complicated to deal with or imposed other restrictive conditions that made it difficult for time-constrained entrepreneurs to secure loans when they were needed.

IntelleGrow's model enables impact enterprises to easily access loans through a viability-based approach to lending that allows fully customizable loans and faster loan processing times. As a result, it takes IntelleGrow an average of four weeks to undertake initial screening and due diligence and issue credit committee approvals (provide a yes/no answer), and an additional two weeks to disburse the loan, thus delivering loans approximately 6 months faster than other formal lenders.<sup>8</sup>

Through its viability-based approach, IntelleGrow is able to customize the structure of its loans to suit the cash flows of borrowers and to preserve a certain level of flexibility and enhance the enterprises' ability to meet customer demand. These loan structures thus help to support the enterprises' growth trajectory and expansion plans. By servicing their loans (many of which represent the first time the enterprise has ever borrowed), these enterprises are also able to build their credit history and lay the foundation for other financial institutions and investors to fund the company to scale over the loan term.



**FIGURE 12: INTELLEGROW HELPS BUSINESSES BRIDGE THEIR 12-48 MONTH GROWTH STAGE, WHICH IS CRUCIAL FOR ACHIEVING SCALE.**

<sup>8</sup> IntelleGrow's fully customized lending products fall broadly into the following categories: short-term working capital loans (6-18 months), term loans (18-36 months), receivables loans (6-24 months) and lines of credit (6-12 months). IntelleGrow's target enterprises are at the growth stage, typically with at least 12 months of track record. Loan sizes vary between INR50 lakh and INR3 crore, while interest rates are customized but tend to be in the range of 18-19 per cent per year, which is seen as marginally higher than commercial bank rates but commensurate with the risk of each particular borrower.

IntelleGrow thereby helps meet the capital financing needs of entrepreneurs through innovative lending solutions in a manner that was absent in India prior to its establishment. IntelleGrow's enterprises can also benefit from the wider range of services that are offered through Intellectap and its partners, which we describe to greater length in the following two subsections. As Figure 11 illustrates, the lending activities of IntelleGrow helps bridge the capital needs of these enterprises during their growth stage, which is a crucial period of their company's development, eventually becoming viable targets for venture capital and private equity funds, and attractive impact investment prospects for market-rate investors seeking a reasonable return.

IntelleGrow recently raised its series A equity and the company is looking to raise money from aligned investors to drive long-term growth. Governments, foundations, development finance institutions and other impact investors can invest in, or support in other ways, the lending capacity of IntelleGrow in various ways, thereby enhancing its ability to help scale these enterprises while earning a reasonable return. IntelleGrow has described how the Indian government's support of an enterprise through procurement contracts has provided the needed source of comfort to make lending possible to certain enterprises. In a particular case, the enterprise's cash flows were extremely erratic, but IntelleGrow was able to negotiate the creation of an escrow account by this company that would be supported by the government, and thus remove some of the uncertainty related to irregular cash flows (Sanjib Jha, IntelleGrow, Personal Communication, May 9, 2013). IntelleGrow is also in discussion with international development agencies that have expressed an interest in underwriting some of its loans going forward. Such forms of support allow IntelleGrow to increase its leverage and attract more equity and debt capital, thereby allowing it to make more loans, thus further strengthening the impact ecosystem in India.

As of June 2013, IntelleGrow had disbursed over 30 loans (with an average size of USD\$225,000), and is on course to achieving its wider mission of building a new market for small business lending in India.

## 5.4 Intellectap Impact Investment Network (I<sup>3</sup>N): Impact Angel Investment Network

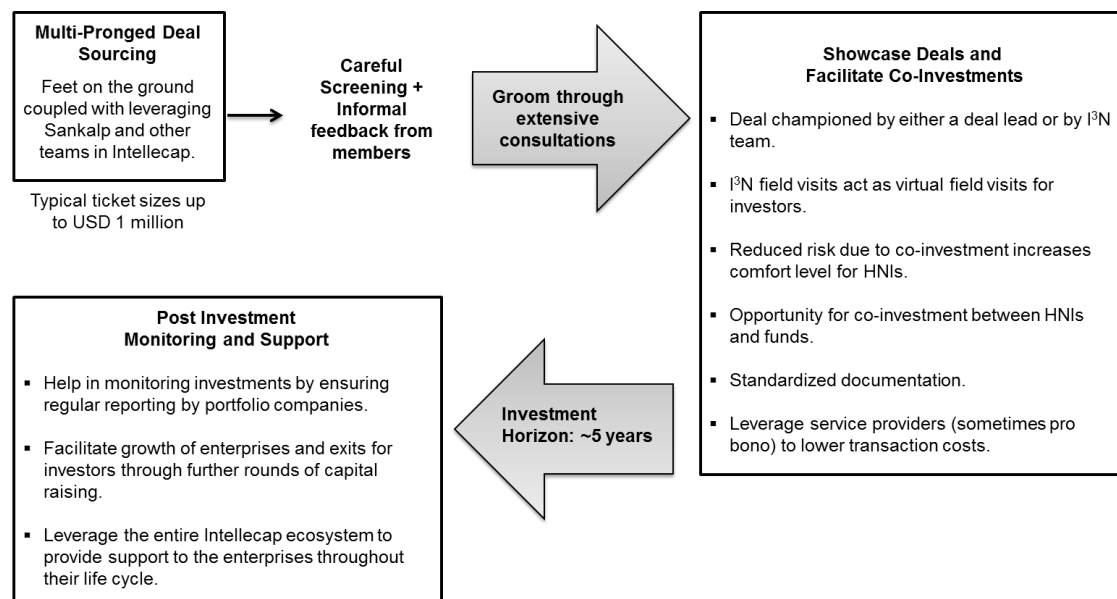
Intellectap's stated objective is to use its positioning at the intersection of the social and business sectors, and combine the business skills of the commercial world with the passion and commitment of the social world to shape distinctive solutions (Anurag Agrawal, Intellectap, Personal Communication, May 9, 2013). Aside from IntelleGrow, it has founded two other initiatives that are designed to contribute to building and catalyzing the social enterprise and impact investing markets in India. One of these initiatives is called the Sankalp Forum, and is Asia's largest social enterprises forum for recognizing and supporting the most innovative, sustainable and high-impact enterprises. The other is I<sup>3</sup>N, which seeks to act as a catalyst for attracting greater angel investment into early-stage impact enterprises.

Although both initiatives are unique and beneficial in their own right, we focus on I<sup>3</sup>N in this report. I<sup>3</sup>N is an angel impact investment network that was launched in 2011 to unlock domestic capital and create a vibrant community of angel investors to address the pre-venture-capital-funding gap that exists in India for impact enterprises. This gap occurs because, historically, investors have avoided financing early-stage/high-risk impact enterprises whose capital needs exceed the threshold for microfunding, ranging up to USD\$1 million, because of the perceived risks involved in these investments. Because of this, about 70 per cent of impact enterprises have been in existence for five years or less, with about 90 per cent of these enterprises having annual revenues of less than USD\$500,000. There is hence significant demand for funding between USD\$100,000 and USD\$500,000, but very few investors that are willing to assume the large business model and execution risks that come with such investments.

What is needed is a strong intermediary that coaches the most promising young enterprises to be ready for investment, and also coaches investors to understand and invest in these enterprises. Although India already had a number of active angel networks, none of them were looking at impact sectors, so the goal of I<sup>3</sup>N was to bring the worlds of angel investing and impact investment together. To make this possible, Intellect first had to “inculcate into angels that they can make an impact, while still making a profit” (Anurag Agrawal, Intellect, Personal Communication, May 9, 2013). Therefore, I<sup>3</sup>N was designed with educational components, including knowledge sharing platforms for sector-deep dives, webinars and monthly newsletters to keep angels updated on deal and event activity in these sectors, and so on.

Operationally, I<sup>3</sup>N brings together diverse angels and funds that have a broad range of preferences, appetites and sector expertise. By bringing together such a network, it provides access to local mentors, guides, and investors that enterprises didn’t have access to earlier. Angels get an opportunity to regularly see an investment-ready set of enterprises and diversify their tech-heavy portfolios with new sectors, while still keeping their risks low by co-investing with others in the network. The funds in the network also get to build a pipeline for future rounds of investment.

Through its unique, multi-pronged sourcing and intensive screening capabilities, I<sup>3</sup>N can achieve deep probing of the market and identify the most impactful and scalable business models. Upon identifying the best early-stage deals, I<sup>3</sup>N undertakes field visits with or on behalf of angels in order to validate its research, and then provides extensive consultations with enterprises to make them investment-ready. The enterprises are then showcased to angels in the network to further evaluate for investment. The I<sup>3</sup>N model facilitates speedy and low-cost transactions by enabling discussions with the enterprises, standardizing transaction documentation, educating entrepreneurs on the terms of investments and by leveraging various low-cost service providers that it is connected to.



**FIGURE 13: I<sup>3</sup>N MODEL DEEP DIVE: INNOVATION IN DEAL-MAKING**

In 2012 I<sup>3</sup>N screened approximately 120 companies, carefully picking 15 to showcase to the angels. Through this process, four of these companies received investments, and I<sup>3</sup>N is in advanced discussions to close two more transactions. These six enterprises are in the education, skills training, healthcare and agriculture sectors. All of them target the lower-income segment of India and promise to generate significant impact while providing a reasonable financial return. Thus, I<sup>3</sup>N has been able to unlock domestic capital from angel investors and contribute to the development of impact enterprises in India by addressing the persistent pre-venture capital funding gap for these enterprises.

Composed of about 30 angel investors, I<sup>3</sup>N is supported by the IFC. Apart from high-network Individuals, its members also include a large number of pioneering organizations such as Toniic, Omidyar Network, Muthoot Pappachan Group and Aavishkaar.

I<sup>3</sup>N hopes to raise a co-investing fund of USD\$10–20 million that would work with these angel investors in nurturing the investments. The presence of angel investors would allow the fund to remain a low-cost intervention and at the same time would create the much needed confidence-building measure for angel investors, helping unlock more capital from the burgeoning investor class that remains unsure of investing in start ups.

I<sup>3</sup>N's kitty of low-cost, high-quality service providers includes the Thomson Reuters Foundation, which accelerates I<sup>3</sup>N enterprises to be considered for pro-bono legal services, and Anuj S Sharma & Co (ASCo), which provides affordable due diligence services to impact enterprises.

## 5.5 Interplay, the Investment Pipeline and Institutional Investors: A Systems View of Impact Investment Initiatives in India

This subsection takes a systems view of the Indian impact investment landscape. By making linkages between the ecosystem building activities of the government and the financial industry as profiled above, it derives various observations about key practices that are needed to further enhance the effectiveness of pioneering impact firms and government initiatives in building this ecosystem.

1. **Address the knowledge gaps of institutional investors:** Institutional investors like pension funds with a long-term horizon are subject to various knowledge gaps when considering asset allocation to and investment selection in the impact sector. Many of these investors still believe that any investment in developing or low-income countries can be considered an impact investment; however, impact investing is actually a very distinct approach. It constitutes a specific subset of investment opportunities in these markets that are coherent with enterprise-based development and particular impact objectives that are typically targeted to lower-income groups in these countries. For institutional investors wanting to invest in impact investing specifically as a distinct investment strategy, significant knowledge gaps exist at the stages of impact investment strategy creation and the implementation of this strategy. Consider the following knowledge needs.
  - a. **Risks:** A significant barrier to greater institutional investment is the lack of understanding about the emerging market-specific risks and the actual business model risks (different from perceived) underlying impact investments in these countries. These are very different from the traditional private equity models that institutions have used historically in these markets. Impact enterprises are subject to a number of differentiated issues, ranging from inadequate infrastructure (e.g., poor transportation networks, erratic electricity) because these companies will typically be focused on rural markets, to unions and tax rule issues. These factors are in addition to myriad emerging market risks and the implementation of innovative business models.

- b. Investment research: To address this needs gap, more research needs to flow to institutional investors to meet their specific needs. Whereas there is currently a lack of information for these investors to make informed decisions and get approval from their investment committees to allocate significant amounts of capital to the impact sector in these markets, it may be necessary for pension funds and the like to start allocating a greater amount of their dedicated research targeted funds towards financing this type of research. Development finance institutions routinely finance these research pieces, but these remain proprietary material. Institutional investor-sponsored research would also be designed to meet their specific needs.
  - c. Impact rating/definition: As previously mentioned, many institutional investors struggle with the definition of impact investing. Due to the nascent nature of the impact sector, there is a need to further define the field of impact investing in developing and low-income countries. Some activity is under way in India to create rate impact enterprises on environmental, social and economic factors. These ratings will allow investors to make more accurate assessments of the impact viability of enterprises and to more easily invest capital according to their stated impact investment approach. These ratings would also increase the transparency of their investments and ensure greater legitimacy.
  - d. Networking and experience: One of the best ways for these investors to gain the needed knowledge and confidence to invest in the impact sector is to participate in investment forums in the country of interest and meet representatives from the industry and government authorities to see what countermeasures are actually in place to address their concerns related to the riskiness and return expectations of the sector. Many dedicated forums are already in existence in India, including the Sankalp forum.
2. **Support national impact investment readiness, staged investing and capital stacking:** All interviewed representatives made reference to the importance of the synergies between the resources that affect organizations like governments, development finance institutions and foundations on the one hand, and financial-first investors like pension funds and high net worth individuals on the other. The strength of the entrepreneurial ecosystem is determined by the ability of these actors to integrate their resources in a complementary manner at strategic leveraging points of the ecosystem.
- a. Complementary ecosystem activities by Aavishkaar, Intellecip and IntelleGrow: The activities of the pioneering Indian impact investment firms that we profiled in this section have contributed to the creation of a growing, vibrant entrepreneurial ecosystem with real social, environmental and economic benefits affecting a significant subset of the Indian population. The activities of pioneering firms like Aavishkaar, IntelleGrow and I<sup>3</sup>N and other Intellecip services fit neatly within the entrepreneurial ecosystem, with all of these firms providing the necessary resources for scaling up impact enterprises through all phases of growth. Intellegrow provides early stage debt in an easily accessible manner, I<sup>3</sup>N provides the equity capital and mentoring needed to bridge the gap between microfunding and USD\$1 million venture capital, and Aavishkaar's patient, hand-holding approach paternalistically guides enterprises to accelerate growth in impact and financial returns. All three firms employ a highly networked model, thereby improving the access of these enterprises to essential services, such as Intellecip's investment banking activities and investment industry relationships for attracting capital at later stages. Aside from providing much-needed capital, they also supply advisory services to ensure adequate enterprise growth and return on investment.

- b. Institutional investment: Institutional investors, however, have so far been lacking in this ecosystem. Therefore, more efforts are needed to lower investment and knowledge barriers by putting in place government policies and programs that can encourage their involvement, as outlined in Section 3, and by lowering the various inefficiencies associated with significant institutional investors' knowledge gaps, as outlined above.
- c. Raising a matching fund: One of the most crucial roles that institutional investors can play in this ecosystem is to provide the needed capital for the consolidation stage of these enterprises once they have matured significantly through the various early stages of growth and capital financing. Once these enterprises have demonstrated a sufficient track record, proof of business models and scalability, institutional investors can buy out these companies, thus providing an exit to early stage investors. At this stage of investing, the impact enterprises will have reached sufficient scale to make institutional investment worthwhile, while at the same time demonstrating sizeable social, environmental and economic impact potential.
- d. Government support: Finally, government support was found to be critical. One of the reasons why impact investing has picked up to such scale in India relative to other countries has been the government's support of financing to priority sectors and underserved populations for the last 40 years and its support of microfinance over the last 15 years. However, preliminary observations suggest that more action is needed by governments to further scale-up the impact sector. Some observers have commented that developed countries like the United States and the United Kingdom have shown much more government support to impact enterprises than those in developing countries, despite there being a greater need and greater financial opportunities in developing countries. Moreover, with the wave of austerity, it is surprising there has not been a greater emphasis on the importance of impact enterprises in effectively delivering social, environmental and economic objectives in developing countries at a low cost to the public sector. And whereas the positive ramifications of impact investing are acknowledged by these governments, there is a sense that the government perceives these enterprises as a threat rather than an ally in delivering their development goals because of a misguided notion that impact enterprises are substitutes for government services. To the contrary, these enterprises are not substitutes, but innovative profit-seeking multipliers of social and economic development effectiveness.

## 6.0 Conclusion

This report has focused on the key problems facing institutional investors wanting to implement impact investment in low-income and developing countries. Upon reviewing the most prominent impact investing research published by leading organizations in the field, we identified seven key issues facing institutional investors. These problems ranged from the lack of investment opportunities meeting investors’ risk-return requirements, to concerns with the scalability of various business models. We list these problems below.

PRIMARY PROBLEMS	SECONDARY PROBLEMS
Investment risk/ return profiles	Impact measurement
Investment track records	Blended capital curve
Exit options	Scalability
	Sourcing deals/ investment costs

We then went on to present a number of complementary measures at the disposal of governments wanting to address some of these barriers to greater institutional investment in their domestic impact sector. As per any investor looking to invest in low-income or developing countries, asset allocation and selection must take into account a variety of country-specific emerging market risks that are related to the political and macroeconomic context of these investments. These factors can include inadequate infrastructure, political instability, market regulation, labour practices, transaction costs and sustainability issues. However, governments may also put policies and programs in place that are targeted specifically at the impact sector. These impact investment policies are typically geared towards strengthening and expanding the pipeline of profitable investments with a sufficient track record to meet investors’ risk-return expectations, all while delivering significant and measurable social, environmental and economic impacts to society. Other measures can support building this pipeline, including: the promotion and support (either direct or indirect) of blended capital structures by governments, favourable tax policies and financial incentives, data requirements and impact reporting and encouraging greater impact investment by domestic institutional investors by way of regulation. Low-income and developing countries may be motivated to utilize these policy levers as part of a greater effort to promote enterprise-based development as a tool for stimulating inclusive economic growth through innovative private sector initiatives.

Innovative financing instruments that can more adequately reflect the risk-return preferences of institutions and other investors are also needed, to better match available capital to impact investment opportunities. Securitization processes can be used to create investment tranches with differential appeals to impact-first investors like governments, foundations and development finance institutions, which primarily seek impacts, accept less return or assume higher risks in achieving their primary goal of maximizing impact. Institutional investors like pension funds and sovereign wealth funds, on the other hand, are primarily profit-seeking and seek to maximize financial returns while targeting a minimal level (floor) of social, environmental or economic impact generation. Thus, financial innovations can promote the achievement of blended capital structures and enhance the accessibility to financing for impact enterprises.

Finally, we applied our focus on complementary government and financial industry initiatives to a case study on India, which allowed us to distill a suite of observations pertaining to the knowledge gaps of institutional investors, and the measures needed to enhance the creation and development of a vibrant national impact investing and entrepreneurial ecosystem in low-income and developing countries. Whereas government support has proven to be instrumental in building the Indian impact ecosystem, we have found that activities by financial industry players like the Aavishkaar Fund

Company, Intellegrow Finance and Intellecap have been critical to the industry’s development as well. Furthermore, a critical ecosystem component has been absent in India and in low-income and developing countries in general—that is, the absent role of institutional investors in completing the top-level of impact investing life cycle and the later-stage investment needs of impact enterprises. Without institutional investors, impact ecosystems lack a fundamental element needed for robust, bottom-up organic growth that is at the core of the spirit of national enterprise-based development strategies.

Leading from this assessment, we believe that the most important concept for both investors and governments to focus on in promoting enterprise-based development in developing and low-income countries is the concept of national impact investment readiness. There is currently a need for shaping government and financial industry measures according to this concept, which can be broadly defined as the ability of a low-income or developing country to consistently and reliably generate and cultivate a large pool of impact enterprises that meet the risk and return expectations of institutional investors. Whereas investors implicitly feed NIIRA factors into their asset allocation to and investment selection of impact investing opportunities, more is needed. They should determine the amount of capital that they seek to allocate to the global impact sector, as well as screen and select national markets and impact sectors within these markets for investing these funds. Low-income and developing country policy-makers need to pay greater attention to these factors in order to effectively implement enterprise-based development in these countries.

An NIIRA is comprised of five main assessment areas, which are all geared towards the evaluation of a country’s ability to generate a pipeline of profitable impact enterprises meeting the risk-return requirements of investors, and the overall size and robustness of this pipeline into the future. This preliminary framework is outlined below.

<p><b>1. National political and economic context</b> (e.g., housekeeping factors, such as macro policies, political economy, local financial markets, corporate governance standards; plumbing factors, such as legal and regulatory frameworks, custody, clearing and settlement and taxes)</p>	<p><b>2. Impact investment policies</b> (e.g., financial, economic, regulatory, technological, skills and information, relevant infrastructure, institutions and networks)</p>	<p><b>3. Financial industry initiatives</b> (e.g., deepness of capital markets, availability of innovative financing, financial players’ programs for enhancing competitiveness of the impact sector; extent to which complementary resources and services are coupled with funding programs)</p>
<p><b>4. Ecosystem completeness</b> (e.g., interaction between all the stakeholders from the impact investment ecosystem, size of impact investment opportunity set and projected size and robustness of the impact investment pipeline into the future; investment readiness of these enterprises)</p>		
<p><b>5. Global fitness</b> (e.g., national entrepreneurialism orientation, impact data measurement and reporting, relations to global investor networks)</p>		

The NIIRA tool will be further developed by IISD, and will be made publicly available for institutional investors and financial institutions wishing to incorporate this framework into their investment decision-making. The tool can also be used to engage governments and policy-makers wishing to further enhance their national support and commitment to enterprise-based development, impact investing and the entrepreneurial ecosystem to deliver social, environmental and economic objectives.

Further implications of this report exist for international development agencies, development finance institutions, foundations and other impact-first investors. National impact investment readiness can be a useful concept for determining the general fitness of national entrepreneurial ecosystems with national and global development goals on a country basis. As a concept linking government and financial industry initiatives to the national ecosystem, NIIRAs can help identify the leverage points for scaling impact investing in individual countries of interest.



We found promising impact investment initiatives around the world that are driven by the intensifying interest of large market-rate investors like pension funds into the impact sector. However, efforts are needed to ensure the legitimacy of their “pro-social” statements. Investors with a long-term horizon can truly be a catalytic force in scaling impact investing, and are a necessary—albeit historically absent—component of robust impact ecosystems; however, assurances are needed to ensure that the impact sector evolves into a legitimate path of development. As with any private-sector-centred strategy for sustainable development, ensuring the proper implementation of the spirit of social, environmental and economic development is critical. For institutional impact investors, this will require the continuous and iterative assessment of their impact investment activities.

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