

THE LANDSCAPE FOR IMPACT INVESTING IN SOUTH ASIA

Understanding the current status,
trends, opportunities, and challenges
in **BANGLADESH, INDIA, MYANMAR,**
NEPAL, PAKISTAN, and SRI LANKA



WITH SUPPORT FROM





Maps within the report are based on UN maps.
Source: UN Cartographic Section

FOREWORD

DEAR READERS,

The Global Impact Investing Network (GIIN) is pleased to publish The Landscape for Impact Investing in South Asia, in partnership with Dalberg Global Development Advisors and with support from UK aid from the UK Government through the Department for International Development's Impact Programme. The first regional market landscape report developed by the GIIN, this report provides a comprehensive overview of the impact investing industry in South Asia, focusing on the countries of Bangladesh, India, Myanmar, Nepal, Pakistan, and Sri Lanka. Through this research, and additional upcoming regional landscaping studies, the GIIN aims to deepen our understanding of investor opportunities at a country-specific level.

The impact investing industry is relatively young, and so the degree of market development varies from one country to the next. This variation is present in South Asia, one of the least developed yet most populous regions in the world—a region with significant potential for impact investing. If we are to accelerate impact investing in South Asia, an understanding of the current state of the market is critical in identifying opportunities for and challenges to deploying impact capital and growing the industry.

Through our partnership with Dalberg, a firm with a strong track record in global development and investment research, we were able to conduct a detailed analysis of capital flows and the current state of impact investing in South Asia. In addition to examining the activities of various impact investors and impact enterprises, the full report highlights the role of key industry actors such as government bodies, investment advisors, incubators, and accelerators.

Looking forward, we are encouraged by clear areas of opportunity, such as the enormous potential market for affordable products and services to meet the needs of “base of the pyramid” populations. There is an undeniable need for improved access to quality housing, healthcare, education, financial services, and energy in South Asia, warranting continued exploration and increased activity in the impact investment market.

We hope this report will accelerate interest, innovation, and investment in the region. Ultimately, this research is intended to inform investors currently deploying capital in the region, and spark further interest from those considering investing in the region.

We look forward to continued work with our network in future landscaping reports, and thank readers of this report for their interest and support.

Sincerely,



Amit Bouri

CEO, The Global Impact Investing Network

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EXECUTIVE SUMMARY



ACKNOWLEDGMENTS

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This report was made possible by the generous contributions of time and expert knowledge from many individuals and organizations. The GIIN Advisory Team provided invaluable insights, guidance, and support throughout the preparation of this report. In addition, we would like to thank all individuals that took part in the interviews and surveys in each of the six countries of study. Through these interviews and surveys, we obtained a wealth of experience, understanding, and data on impact investing activities in South Asia. We would also like to acknowledge the country experts who provided critical feedback on our preliminary findings. A full list of the interviewees, survey respondents, and country experts can be found in the Appendices.

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LIST OF COMMON ACRONYMS

ADB Asian Development Bank	MDG Millennium Development Goal
AIF Alternative Investment Funds	MEB Myanmar Economic Bank
BoP Base of the Pyramid	MFI Microfinance Institution
BRICS Brazil, Russia, India, China, South Africa	MFTB Myanmar Foreign Trade Bank
CA Chartered Accountancy	MNC Multinational Corporation
CIIE Centre for Innovation, Incubation and Entrepreneurship	MICB Myanmar Investment and Commercial Bank
CGTMSE Credit Guarantee Fund Trust for Micro & Small Enterprises (India)	NABARD National Bank for Agriculture and Rural Development
CSR Corporate Social Responsibility	NASE National Association of Social Enterprises (India)
DFI Development Finance Institution	NEDA National Enterprise Development Authority (Sri Lanka)
DFID Department for International Development	OPIC Overseas Private Investment Corporation
FIL Foreign Investment Law	PE Private Equity
FDI Foreign Direct Investment	PM Prime Minister
GAAR General Anti-Avoidance Rules (India)	PPP Purchasing Power Parity
GIZ Gesellschaft für Internationale Zusammenarbeit (German Agency for International Cooperation)	RBI Reserve Bank of India
HDI Human Development Index	SEBI Securities and Exchange Board of India
HNWI High Net-Worth Individual	SIB Social Impact Bond
HR Human Resources	SIDBI Small Industries Development Bank of India
ICT Information and Communication Technology	SME Small or Medium Enterprise
IFC International Finance Corporation	SMED Small and Medium Enterprise Development (Sri Lanka)
IFI International Financial Institution	SVF Social Venture Fund
IE Impact Enterprise	VC Venture Capital
IIC Impact Investors' Council (India)	WHO World Health Organization
IMF International Monetary Fund	
LP Limited Partner	
LTTE Liberation Tigers of Tamil Eelam	

OVERVIEW AND CURRENT STATE OF THE MARKET

This extensive report aims to provide a “state of the market” landscape analysis of the impact investing industry in six countries across South Asia—Bangladesh, India, Myanmar, Nepal, Pakistan, and Sri Lanka.¹ Impact investments, as defined by the Global Impact Investing Network (GIIN), are investments that intentionally seek to generate social and/or environmental impact alongside a financial return. In addition, the report captures other activity that may be relevant for impact investors, such as investments at the base of the economic pyramid that may lack an explicit intention for positive impact.

Overall, although the market activity and dynamics of impact investing differ among the countries under study, the countries do share some common trends and areas of opportunity, as well as common challenges to be mitigated.

India is the largest and most active impact investing market in the region (see Figure 1), benefiting from a broad range of investor and entrepreneur experience with impact investing. To date development finance institutions (DFIs) have deployed USD 5 billion while other impact investors have deployed USD 437 million. However, there is still room for growth in several areas, such as the development and use of a wider range of instruments, gap filling in early-stage investing, and the development of strategic and consistent impact measurement practices.

FIGURE 1A: KNOWN CAPITAL DEPLOYED BY DFIS, USD MILLIONS

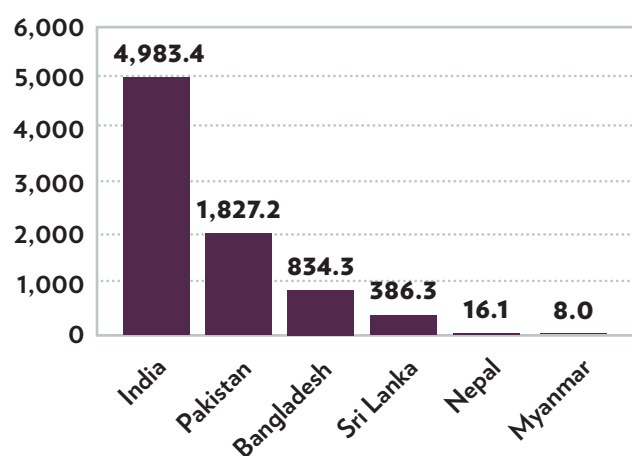
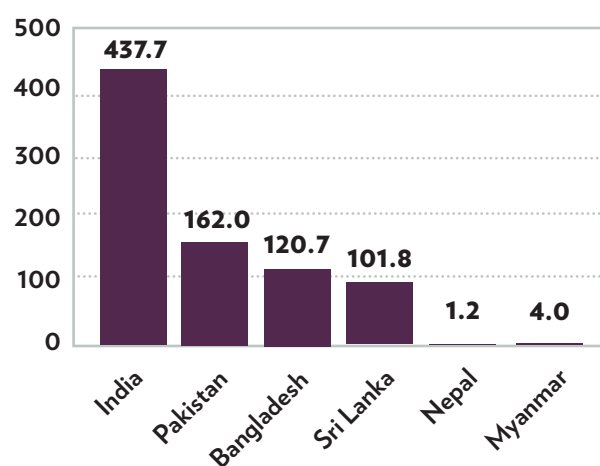


FIGURE 1B: KNOWN CAPITAL DEPLOYED BY NON-DFI IMPACT INVESTORS, USD MILLIONS



Source: Dalberg analysis. Notes: Figures represent aggregate capital deployed from 2004-2014. The majority of the capital represented here was deployed between 2009 and 2014. This is due in part to the limited availability of data for 2004-2009.

¹ Chapters on Bangladesh, Nepal, and Pakistan as well as an introductory section (“Setting the Scene”) were published in December 2014 along with this Executive Summary.

After India, Pakistan and Bangladesh are the most active countries for impact investing in the region. Non-DFI impact investors have deployed USD 162 million and USD 121 million in Pakistan and Bangladesh, respectively. DFIs, for their part, have deployed USD 1.8 billion and USD 834 million. In Pakistan, while political instability and terrorism are major concerns for many foreign investors, the domestic business community remains largely undeterred by these factors. Rather, domestic investors and fund managers in Pakistan have demonstrated optimism about the industry, given the large domestic market, relatively favorable regulatory environment, strong history of entrepreneurial activity, and interest from some foreign providers of impact capital. In Bangladesh, market potential (based on GDP and large population), and a long-standing presence of development finance institutions (DFIs) are key facilitators of impact investment.

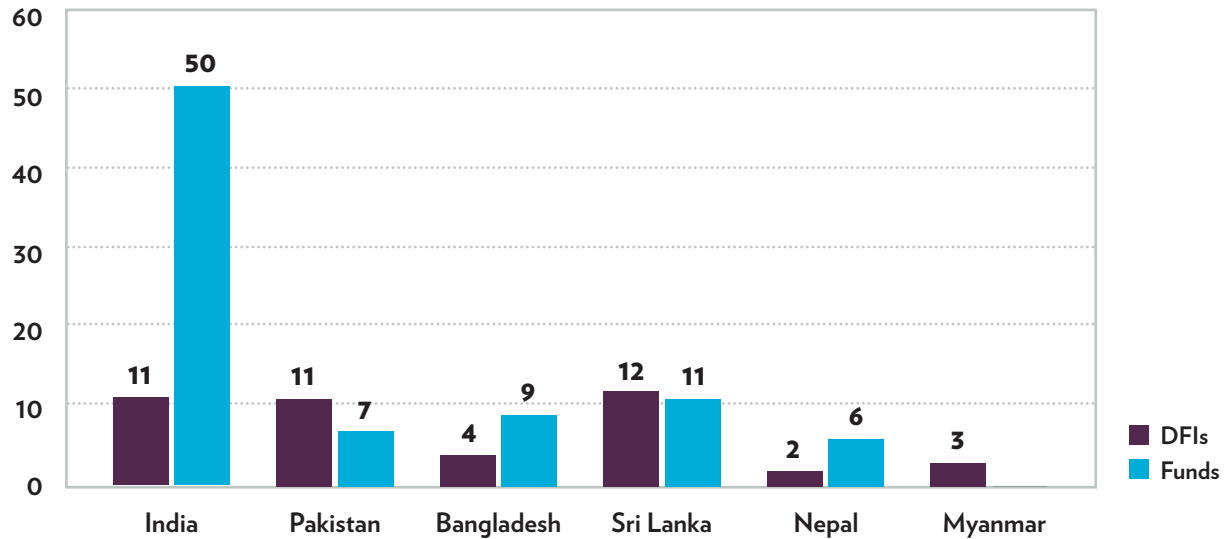
Myanmar and Sri Lanka are two of the fastest growing economies in the region, and impact investors considered in this study have shown a strong interest in these two countries. In Myanmar, while only USD 12 million has been deployed to date, a further USD 109 million has been committed by various investors for deployment in the next two to four years. Sri Lanka offers a relatively favorable regulatory environment for investors. However, in both these countries, small overall market sizes and gaps in enterprise capacity pose challenges for investors. Still, over USD 100 million has been deployed to date by non-DFI impact investors in Sri Lanka and a further USD 386 million has been deployed by DFIs, demonstrating the potential for capital flows across the region if the market climates are investment-friendly.

In Nepal, despite strong macroeconomic growth trends and recent improvements in the investment climate, there has been relatively little impact investing activity (as well as little overall investing activity). Nevertheless, there has been some growth and impact investor interest in certain economic sectors such as hydropower and tourism. In addition, approximately USD 54 million has been raised or committed by DFIs and funds; however, this money has not yet been deployed.

Roughly a dozen DFIs have deployed capital in each of India, Pakistan, and Sri Lanka, while a smaller number have been active in Bangladesh, Nepal, and Myanmar. Across the region, most (65-95%) of the impact capital currently originates from DFIs and is then deployed either directly into enterprises and projects or through funds of varying sizes. DFIs' role as a dominant capital provider puts them in a position to drive trends in investment practice and impact measurement. In some countries, they also play a role in influencing the policies and the regulatory environment for investment.

There are also many impact investment funds active across countries in the region. Most impact funds have a multi-geographic focus, including not just multiple countries in the region but a variety of countries worldwide. Bangladesh and India are the only countries with a handful (three or more) of country-specific impact funds with deployed capital. Five country-specific impact funds have been established in Nepal; however, only one of these has currently deployed capital (as of 2014). Overall, there are roughly 50 impact investment funds active in India, 11 in Sri Lanka, nine in Bangladesh and seven in Pakistan. These funds raise capital from a variety of sources, including DFIs, institutional investors (pension funds and insurance companies), family offices, high-net-worth individuals (HNWIs), commercial banks, and foundations. Some family offices, HNWIs, and foundations are also active in making direct impact investments.

FIGURE 2: NUMBER OF IMPACT FUNDS AND DFIS ACTIVE IN SOUTH ASIA



Source: Dalberg analysis. Notes: Nepal has five country-specific impact funds; however, only one of these has currently deployed capital.

There are also several funds, banks, and family offices/HNWIs active in South Asia that are making investments on the periphery of impact investing—for instance, those who invest in enterprises providing goods, services, or employment to populations at the base of the economic pyramid (BoP), but without explicit impact intent.² These include local wealthy families and individuals who often provide start-up financing, particularly to entrepreneurs within their family or social networks. Many local commercial banks, meanwhile, provide debt financing to SMEs (often mandated by policy) at the behest of DFIs.

Impact investors in the region target their investments in a number of ways, including one or both of the following:

1. by the intention of the enterprise to create impact (“impact enterprises”—see side bar for definition);
2. by the potential of the enterprise to create impact (regardless of whether it explicitly intends to do so), e.g., investing in SMEs that can provide local employment; investing in enterprises in sectors the investor considers inherently impactful, such as health and education; or investing in high-growth sectors with job creation potential, such as manufacturing.

Thus far, across the region, only a relatively small proportion of the total capital deployed by impact investors has been directed at impact

For this study, we define **impact enterprises** as those that

- have articulated a core objective to generate positive social or environmental impact (as a part of their operating model rather than an ancillary activity); and
- seek to grow to financial viability and sustainability

² In this report, we use “base of the pyramid (BoP)” as a general term to refer to poor or low-income populations, with no specific threshold in terms of income level.

enterprises, perhaps due to the small investment sizes required (along with relatively high transaction costs), the limited pipeline of the investment-ready impact enterprises, and the fact that self-defining as an “impact enterprise” is itself an emerging practice.

OPPORTUNITIES

SECTORS

The markets in South Asia offer a diverse array of investment opportunities in different sectors. Across the region as a whole, the largest amounts of capital have been deployed in the sectors of energy, financial services (including microfinance), and manufacturing, and these remain active sectors for investment. There is notable variation between the sectors targeted by DFIs and those targeted by other impact investors, with the former preferring sectors that are able to absorb large investments, while the latter are more readily able to target impact enterprises. For instance, DFI energy investments have focused on large scale infrastructure projects, whereas energy investments by other impact investors have supported smaller, off-grid technologies. Similarly, DFI investments in financial services have targeted bigger banks, while financial services investments by other impact investors have focused more on microfinance institutions.

There is also growing interest among impact investors in other sectors such as agro-business, health, and information and communication technology (ICT), and in businesses providing basic goods and services to the base-of-the-pyramid (BoP) consumers.

FIGURE 3A: KNOWN CAPITAL DEPLOYED BY DFIs, USD MILLIONS

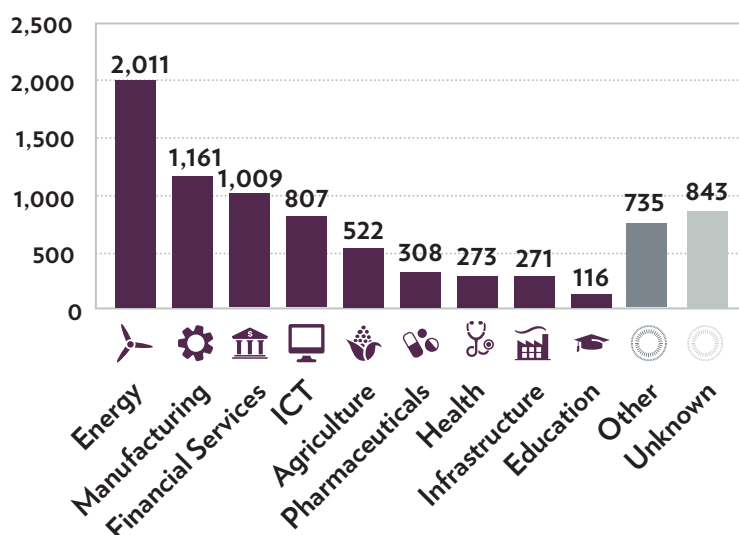
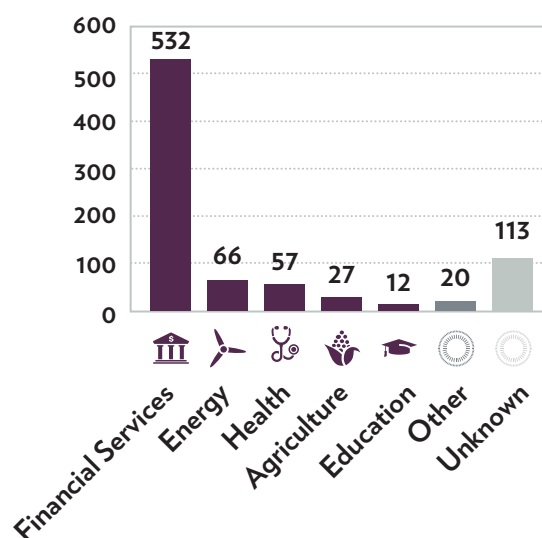


FIGURE 3B: KNOWN CAPITAL DEPLOYED BY NON-DFI IMPACT INVESTORS, USD MILLIONS



Source: Dalberg analysis. Note: Figures includes the overall totals across all six countries considered in this study.

TABLE 1: OVERVIEW OF KEY IMPACT INVESTING SECTORS IN SOUTH ASIA

India		<p>Most impact capital has been deployed in the manufacturing, financial services, and energy (both renewable and non-renewable) sectors, and a sizeable number of deals have been in other sectors such as education and healthcare. Funds are shifting toward a less opportunistic and more hypothesis-driven approach to selection; in this new approach, these funds start with the identification of a problem in a given sector, then identify a potential solution (hypothesis), and subsequently seek organizations that contribute to this solution.</p>
Pakistan		<p>Energy, financial services (microfinance institutions (MFIs) and others), and manufacturing have been the most attractive sectors to date. Impact investors see high potential in businesses serving the large domestic consumer base. Angel investors on the periphery of impact investing are particularly drawn to ICT-related investment targets.</p>
Bangladesh		<p>Most impact capital has been deployed in growing sectors such as ICT, energy, and manufacturing, particularly as many investors target job creation as their main impact objective and see these sectors as having the best potential to meet this core goal.</p>
Sri Lanka		<p>Microfinance and other financial services have drawn the bulk of impact capital. Tourism and hospitality have been attractive to investors as well. There is a growing interest in investment in BoP-focused enterprises in the ICT, energy, health, and technology sectors.</p>
Nepal		<p>Transportation and tourism have drawn the largest proportion of impact capital to date—these sectors are attractive because they can absorb large ticket-size investments. For the future, impact investors are excited about opportunities in hydropower and tourism, which have been growing and are expected to continue to do so.</p>
Myanmar		<p>To date, most impact capital has been deployed in real estate due to a dearth of investible opportunities in other sectors. There is a strong interest among impact investors in financial inclusion for future investments.</p>

PRODUCT AND INSTRUMENT DEVELOPMENT

Across the region, the majority of impact capital deployed by DFIs has been through debt instruments. On the other hand, the majority of capital deployed by other impact investors has been through equity. DFIs prefer debt for several reasons, including a lower risk appetite (given that they are investing taxpayer money), a lower level of due diligence required as compared to making equity investments, and less active management of the investment when compared with equity investments. In some countries, regulations can be unclear and restrictive regarding equity, further driving the preference for debt. Although interest exists in some countries around exploring new instruments such as quasi-equity, thus far, there has been little experience with these alternatives.

FIGURE 4A: KNOWN CAPITAL DEPLOYED BY DFIS, USD MILLIONS

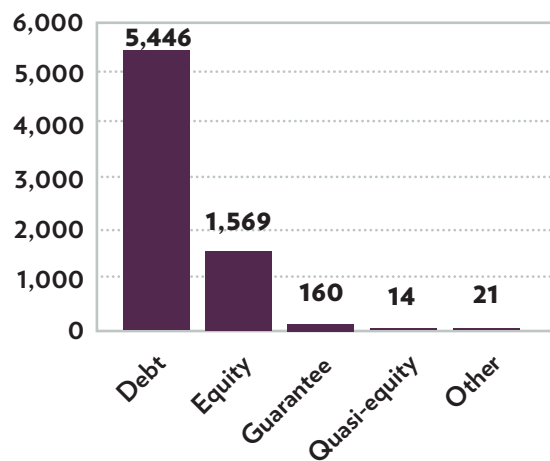
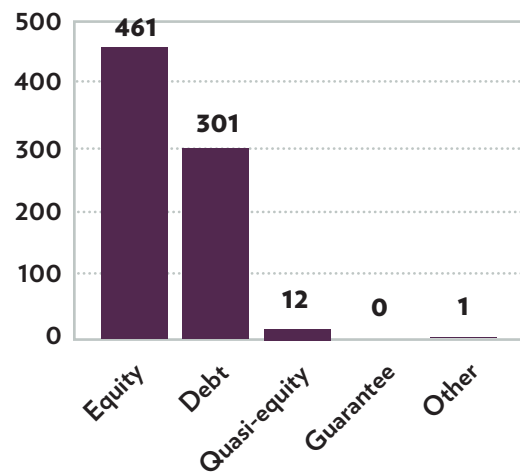


FIGURE 4B: KNOWN CAPITAL DEPLOYED BY NON-DFI IMPACT INVESTORS, USD MILLIONS



Sources: Stakeholder interviews; Investor websites; Dalberg analysis. Note: Capital deployed where instrument is unknown not included in charts.

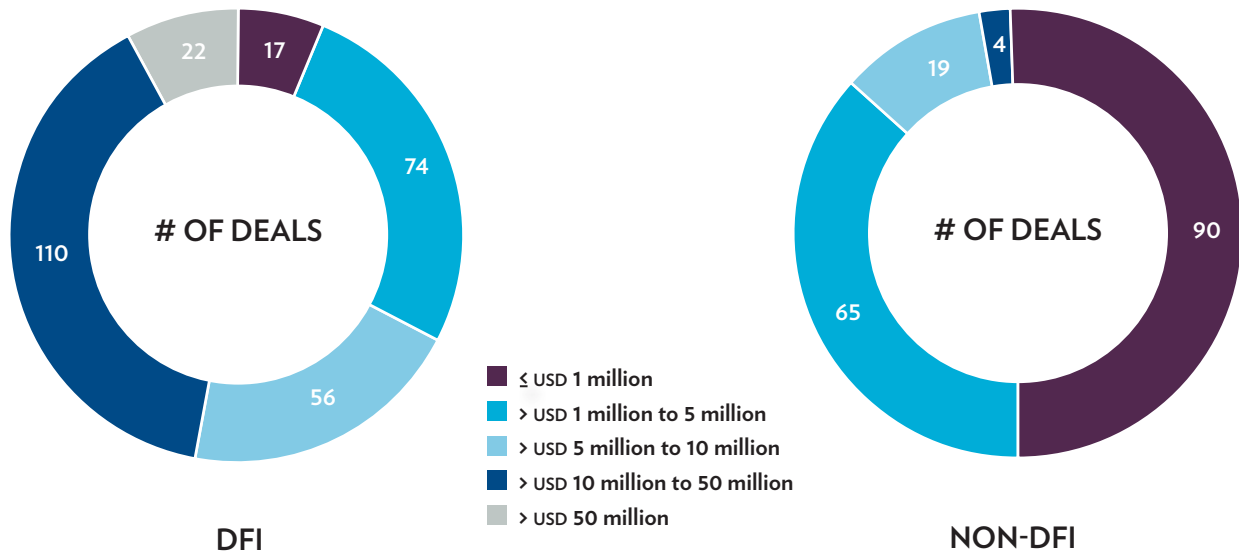
Opportunities for product and instrument development vary across the region, as detailed in the table below.

TABLE 2: OVERVIEW OF MIX OF INSTRUMENT USE IN IMPACT INVESTING IN SOUTH ASIA

India		Debt is the most common instrument in terms of the amount of capital, particularly because the primary source of overall capital is DFIs, who prefer debt instruments. However, DFIs indicate a growing preference for equity instruments in order to establish more integrated partnerships with their investees. Foreign funds are prohibited from investing in debt and, as a result, most of the capital from impact funds is deployed through equity instruments. Consequently, small domestic funds are emerging to fulfill the need for early-stage debt.
Pakistan		Most impact capital has been deployed through debt driven by DFI investors. Interest in quasi-equity has been articulated by impact investors, but thus far, there haven't been any deals. The interest derives from the perceived difficulty of exiting pure equity investments (there have been no impact equity exits in Pakistan to date).
Bangladesh		Most impact capital has been deployed through debt, with which both investors and entrepreneurs tend to have greater familiarity and comfort. Regulatory restrictions on equity investments (e.g., a three-year lock-in after public listing and lack of certain protections for investors and investees) also fuel the preference for debt.
Sri Lanka		Debt accounts for a majority of impact capital deployed, with early-stage investments tending toward equity. Impact investors have also provided some small to mid-sized guarantees to support access to finance for SMEs and non-bank microfinance institutions.
Nepal		Debt is preferred, due in large part to the lack of a developed regulatory framework for equity. However, equity is being tested in small amounts by investors that are not legally registered as lending institutions and therefore, are not allowed to provide debt.
Myanmar		Debt is preferred among both current and future impact investors, again driven by the fact that most of the capital is deployed by DFIs. Foreign investors are prohibited from debt transactions, so they will have to invest through equity or other instruments as they enter the market.

Direct investments by DFIs tend to target mature companies, as DFIs prefer relatively large deal sizes that only mature companies are able to absorb. Investments in more mature companies are relatively easy because risk is mitigated by operating and financial histories and transaction costs are more easily accommodated by large deals. On the other hand, smaller investments in early-stage companies (start-ups as well as companies in early growth phases) are challenging and have been more limited to date. Thus, most DFI investments have been in the USD 10-50 million range, with a handful even above USD 50 million. In contrast, most investments by non-DFI investors have been below USD 1 million, and thus typically into growth and venture stage organizations.

FIGURE 5: IMPACT INVESTMENTS BY SIZE OF DEAL IN SOUTH ASIA



Sources: Dalberg analysis.

CHALLENGES

In taking advantage of these opportunities, investors will need to bear in mind several challenges. While these challenges do not pose insurmountable obstacles to impact investing in the region, they need to be understood by investors and other stakeholders so that they can be mitigated, circumvented, or resolved. Key barriers include regulatory issues, difficulties in deal sourcing, and issues of scale in terms of portfolios and deal sizes.

REGULATORY ENVIRONMENTS

Challenges in navigating regulatory environments—affecting both impact and conventional investors—are a common theme across countries, although there is some variation by country. These challenges tend to be related to complexity, variability, inefficiency, and restrictiveness. For example, in India, relevant laws and policies have repeatedly changed over the past few years. Currently, there are also restrictions on the use of various instruments: foreign investors cannot make pure debt investments, and certain structured products are not sanctioned by the Reserve Bank of India (e.g., non-convertible preferred shares). Entrepreneurs also face barriers in establishing and scaling businesses, as bureaucratic processes add to the transaction costs and time required to establish a business and to maintain compliance with regulations during growth phases.

In Bangladesh, foreign equity investors face the dual challenge of regulations related to a) local companies accepting foreign capital (which requires separate registration) and b) establishing a locally domiciled fund (through a lengthy and complex process). In addition, there are unclear or unfavorable regulations around public offerings (e.g., a three-year lock-in period). Nepal’s environment is characterized by general uncertainty as the country does not currently have a constitution, and regulations for equity (a new instrument in the country) have not yet been defined. In Myanmar, the key regulatory constraints include complex and opaque screening and investment approval mechanisms, regulations that prohibit most foreign investors from debt lending, and complicated separate laws governing foreign and domestic investment. Although not completely devoid of challenges, Sri Lanka’s and Pakistan’s regulatory environments are relatively favorable for investment and enterprise.

TABLE 3: SUMMARY OF CONSTRAINTS BY INVESTMENT STAGE



DEAL SOURCING

Sourcing deals that meet various investor requirements of impact potential, risk, return, and size of investment is challenging. Impact capital across the region tends to be concentrated in certain sectors (particularly energy and microfinance) and stages of business (growth stage for funds and mature companies for DFIs). There is also a need to bring less-exposed enterprises into the fold in a number of countries. Even in India, where formal networks of entrepreneurs exist, it is difficult to find enterprises that are not a part of these networks. Additionally, in many countries studied, there is a gap between investor and investee expectations. This is due in part to the entrepreneurs' limited comfort and familiarity with investment concepts such as ownership, equity, and valuation.

SCALE

Many investors face scale issues related to small market sizes (particularly in Sri Lanka and Nepal) and to small enterprise sizes across the region. Therefore, there is a need for vehicles to deploy smaller sums of capital, particularly in early-stage deals. However, funds seeking DFI investment often need to establish larger funds that deploy in larger ticket sizes (e.g., more than USD 1 million). This is because DFIs often have minimum investment sizes (e.g., USD 20 million) plus a requirement that their stake be no more than a certain percentage of total capital in the fund (e.g., 25-30%). This also presents a challenge for fund managers to raise enough matching capital to secure the DFI anchor investment.

Constraints vary by country and by stage of investment process, reflecting the differing investment environments and enterprise landscapes of the countries in the region. For example, while entry (e.g., establishing a fund or presence in the country) is a challenge in Myanmar and Nepal due to regulatory and fundraising issues, in India, Pakistan, and Sri Lanka, the more severe challenges come at the later stages of the process such as due diligence, deal structuring, and exit. Table 3 illustrates this variation, and details on these constraints can be found in the country chapters.

REPORT STRUCTURE

In the chapters that follow, readers will find greater depth and detail on the current state of and future opportunities for impact investing in each of the six countries in this study. Each chapter includes sections on the general country context, the supply of impact investing capital, the demand for capital from potential investees, and the ecosystem that supports the actors involved in impact investing. We hope that this information proves useful for both investors already active in the region and potential investors currently scoping new opportunities. As the country chapters show, the region is diverse and full of potential for making sound investments that can both generate a financial return and address a host of social and environmental issues.

INTRODUCTION



SETTING THE SCENE

Introduction and objectives

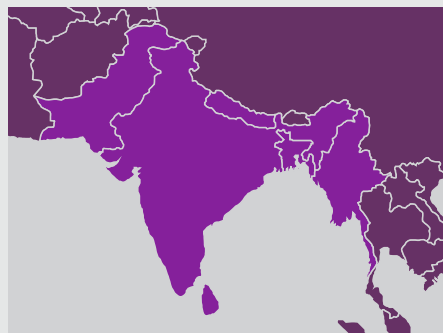
In recent years, impact investing has gained prominence on the global stage as an approach to deploying capital with social/environmental goals as well as financial return objectives. Deployed in both developing and developed markets, impact investments are made across a range of sectors and asset classes.

South Asia* is home to more than 1.6 billion people and has experienced significant economic growth over the last decade. However, this rapid growth, while changing some economies dramatically, has been uneven between and within countries; about a quarter of the region's population continues to live on less than USD 1.25 per day.³ Nonetheless, the region presents enormous opportunities as a large market with a significant share of its population being young and potentially economically active; approximately 30%⁴ of the population is currently under the age of 15, creating a future demographic bulge that presents an opportunity to develop human capital and nurture entrepreneurship.

Within South Asia, we see enormous variation between countries in terms of population size, economic growth and market maturity, entrepreneurial activity, and indeed, investing activity (both impact and conventional). The impact investing model is most well established in India, with pioneers such as Aavishkaar and Acumen active since the early 2000s. The industry has grown dramatically with almost 50 funds now active in the market, a huge range of impact enterprise models of varying scales and across many sectors, and a vibrant and robust ecosystem to support these actors. Pakistan, Bangladesh, and Sri Lanka also have markets that are sizeable in their own right, while investors are actively thinking about opportunities being presented in Nepal and Myanmar—two countries going through fundamental political and economic transformations.

With the population of India at 1.2 billion in 2012, and the additional combined populations of Bangladesh, Myanmar, Nepal, Pakistan, and Sri Lanka at close to 450 million people, South Asia represents an enormous potential market for products and services. South Asia also presents a particular set of needs and opportunities for the so-called base of the pyramid (BoP) populations⁵ who largely lack access to quality

*South Asia, for the purposes of this study, includes



- Bangladesh
- India
- Myanmar
- Nepal
- Pakistan
- Sri Lanka

Map is based on UN map.
Source: UN Cartographic Section.

³ Weighted average calculated with the latest country data (2010–2012) from World Bank Development Indicators; Myanmar figures are not included in the weighted average.

⁴ Weighted average calculated with the latest country data (2013) from World Bank Development Indicators.

⁵ In this report, we use “base of the pyramid (BoP)” as a general term to refer to poor or low-income populations, with no specific threshold in terms of income level.

social services, finance, energy, and infrastructure as well as to affordable consumer products. The opportunity for impact through the deployment of capital into organizations and enterprises that increase incomes, create jobs, and provide access to essential services is significant, and the status of the impact investing industries in these countries is worthy of attention.

The objective of this study is to develop an understanding of the status of the impact investing markets in these countries, as a critical input to future investments and engagement to build and grow these markets. The key themes explored include the current status and trends in terms of the types of active investors, capital deployment, opportunities for and challenges to investing, the demand for impact capital, challenges to accessing capital and opportunities for enterprise growth, and the vibrancy and scale of the supportive ecosystem for the industry.

Defining key terms and concepts

THE SUPPLY SIDE: WHO IS AN IMPACT INVESTOR?

As defined by the Global Impact Investing Network (GIIN), impact investments are **“investments made into companies, organizations, and funds with the intention to generate social and environmental impact alongside a financial return.”**⁶

The three key characteristics of an impact investor are as follows:

1. Expectation of a financial return that can range from the return of capital to risk-adjusted market-rate returns and that can be derived from investments in a range of asset classes. Impact investors may also earn fees from the provision of catalytic instruments such as guarantees.
2. Intent to generate positive social and/or environmental impact through investments. For example, investors may seek to use investments to increase access to financial services, education, healthcare, affordable housing, or quality employment by underserved populations. Investors may also invest in solutions aimed at mitigating the negative effects of climate change and environmental degradation.
3. Commitment of the investor to measure the social/environmental performance of the underlying investments.

This report focuses significantly on the impact investing landscape in each of the six countries covered. Various terms may be used to refer to the impact investing landscape, including “impact capital” and “impact funds,” depending on the context. For the sake of fluency, the modifier “impact” will be dropped when the context is clear.

While the central goal of this study is to map the current landscape of impact investing activity in South Asia, there is also significant investment activity on the

⁶ For more details, refer to the GIIN website, www.thegiin.org.

periphery of “impact investing” that is interesting to explore. In particular, we consider the following two types of investment activity:

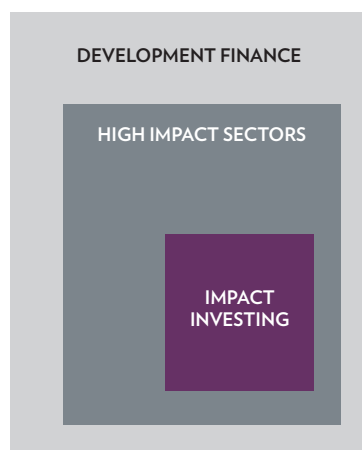
- a. Investments in businesses serving BoP populations by investors who have no explicit impact intention
- b. Investments where there is some intention to have social and/or environmental impact, but this impact is assumed to occur as a by-product and is not measured in any meaningful way

An analysis of such investment activity is also important for understanding the broader opportunity landscape for impact investing in the future. When a section in the report focuses specifically on investment activity in this peripheral region, we will refer explicitly to such investment activity as “**impact-related**” investments, clearly differentiating them from “impact investing.” (Please note that we are using these labels purely for the ease of reference and do not intend the names to imply any subjective judgment on the nature of an investor’s investment activity or approach.)

One simplifying feature of this framework is that it is investor-driven rather than transaction-driven. In the impact investing market, there is a healthy ongoing debate on whether a particular investment should be treated as an “impact investment.” Often, this debate centers on the portfolios of DFIs, who tend to be large players, and invest across a range of sectors and organization types—from small microfinance institutions to large land conservation and real estate projects. Accordingly, while some are happy to consider all DFI activity as “impact investing,” others would argue that a more considered segmentation needs to be applied to DFI portfolios.

PORTFOLIO SEGMENTATION: THE OPIC APPROACH

A recent announcement by OPIC’s President described their new approach to segmenting their portfolio based on impact intention at the investment level, and the rationale for the approach. Recognizing the learning from the growth of impact investing that “there are rarely clear, bright lines that distinguish true impact intent from investing with impact,” OPIC shared their categorization approach with a view to help inform the ongoing debate around how best to define impact investing, as well as to support other agencies as they think through their own impact portfolios.



- **Development finance:** All of OPIC’s financial commitments aim to have a positive development impact. By definition, the projects we support are expected to demonstrate positive development, social, and financial returns while safeguarding against damage to the environment and promoting high-quality job creation.
- **High impact sectors:** Investments in sectors generally associated with impact investing. These sectors face the most difficult challenges in attracting capital: agriculture, education, access to finance, housing for the poor, small and medium enterprise finance, healthcare, renewable energy, water, and sanitation. Given the far easier investment options, these are sectors investors would only engage in out of a deep commitment to impact.
- **Impact investing:** These investments had an explicit and inherent intent at startup to address environmental or social issues, as well as a business model with a structure dedicated to achieving both impact and financial returns. To select these transactions, projects in impact sectors were first identified, and then project teams were asked to identify impact intent at origination, reviewing project sponsor’s intent to generate impact.

It is an interesting development to note that some DFIs have, indeed, recently begun thinking more carefully about their overall portfolios and how these are segmented (see boxed note on OPIC, the US Overseas Private Investment Corporation). However, these exercises are still early-stage, and it would be premature to begin segmenting DFI portfolios (or any investor's portfolio for that matter) in our own research at this stage. Therefore, for the purposes of this study, we have chosen to be investor-driven, i.e., to apply a common intentionality standard across an investor's entire portfolio. While we recognize that this may be simplifying, we find that the approach does not detract from our ability to conduct detailed analyses of and obtain a nuanced understanding of the opportunities and challenges across the countries under study.

THE DEMAND SIDE: WHERE IS THE IMPACT CAPITAL GOING?

With impact investing being defined primarily by the intention of the investors, and not necessarily the intention or approach of the investees, the types of organizations that absorb capital from impact investors vary.

As will be described in the individual country landscapes, we see a different set of target enterprises absorbing the impact capital in each country. One subset that is important to call out is "impact enterprises." Impact enterprises (sometimes called social enterprises or inclusive businesses) have been variously defined as follows:

- The IFC defines an inclusive business as one that "expands access to goods, services, and livelihood opportunities for those at the BoP in commercially viable, scalable ways."⁷
- The ADB defines a social enterprise as one meeting the following three key criteria: 1) exists primarily to create specific positive social or environmental impact (as opposed to ancillary or secondary initiatives, such as a company's Corporate Social Responsibility (CSR) program); 2) adopts a market orientation; and 3) focuses on financial sustainability.⁸
- The Rockefeller Foundation describes impact enterprises as "enterprises that intentionally seek to grow to sustain financial viability, realize increasing social impact, and influence the broader system in which they operate."⁹

7 Jenkins, B; Ishikawa, E; Geaneotes, A; Baptista, P; and Masuoka, T, *Accelerating inclusive business opportunities: Business models that make a difference*, Washington, DC: IFC, 2011.

8 *Asian Development Bank*, *Impact investors in Asia: Characteristics and preferences for investing in social enterprises in Asia and the Pacific*, 2011.

9 *Rockefeller Foundation*, *Innovations in accelerating impact enterprise growth to scale*, <<http://www.rockefellerfoundation.org/our-work/current-work/innovation/impact-enterprise>>

Paraphrasing from the above definitions, for this study, **we describe impact enterprises as enterprises that¹⁰**

- **have articulated a core objective to generate a positive social or environmental impact (i.e., as a part of their operating model rather than an ancillary activity as with CSR programs), and**
- **seek to grow to financial viability and sustainability.**

In more mature impact investing markets such as India, and in the rapidly growing markets of Pakistan, Bangladesh, and Sri Lanka, we see a large number of successful impact enterprises; many of these have reached significant scale, making them strong investment targets for impact investors. Further, a relatively large volume of impact capital in these markets may be directed into such business models. However, in less mature markets, where the impact enterprise model is less embedded or where the scale is still small, we see the impact capital directed to a broader range of enterprises.

Approach and Methodology

The content and analysis presented in this study are developed from both a review of the existing literature and extensive primary data collection as detailed below.

The data and perspectives gathered from both the primary and the secondary research were synthesized to arrive at the estimates of the total capital flow, key trends, and preferences by sector, instrument, deal size, and growth stage. In specific cases where detailed information was missing, we made assumptions on the split of capital between sectors or investment categories and, subsequently, validated our outputs through expert interviews. All of our assumptions are clearly annotated in the corresponding analyses.

The existing literature on impact investing in the region is sparse, except for India, for which there is a growing body of research that we have analyzed in depth. Consequently, our analysis both builds on the existing literature and outlines where our findings differ from the findings of other related studies.

Overall, given the limited volume of the existing research, the research process relied heavily on the primary data collection. Three tools were used for primary data collection to capture activities and perspectives across the investor, enterprise, and ecosystem categories. These tools are as follows:

¹⁰ *To note, this definition does not represent a perspective articulated by the GIIN across its global activities but is developed and adopted for the purposes of this study in order to enable a description and discussion within the context of the six countries considered in this study.*

INDIVIDUAL SEMI-STRUCTURED STAKEHOLDER INTERVIEWS

More than 135 interviews were conducted across the six countries included in this study, with investors, entrepreneurs, and other market stakeholders active in or scoping the region.

Interviews with investors were used for gathering data on investment portfolios and other activities, key trends observed, challenges faced, and opportunities perceived. With entrepreneurs, we conducted interviews to understand business models and rationale, opportunities for and challenges to growth, sources of finance, and perspectives on and preferences for instruments and investors. Within the ecosystem, we sought to interview across the range of relevant players, including regulators/policymakers, professional service providers, business development service providers, and incubators/accelerators.

ONLINE QUESTIONNAIRE DISTRIBUTED TO INVESTORS AND ENTREPRENEURS

To supplement the interviews described above, a questionnaire was developed for distribution and completion online by investors and entrepreneurs with whom it was difficult or impractical to schedule individual conversations (n=58). The similarity of questions allowed for the collection of both comparable data and supplemental data.

EXPERT ADVISORY GROUPS

In the final phase of the study, between two and four expert advisors for each country under study were convened, and the conversations facilitated the sharing of emerging findings, collection of feedback, and validation of perspectives. Expert advisors were selected from previous interactions for their broad view on the market and awareness of key actors and activities, as well as for a balance of perspectives across the supply, demand, and ecosystem segments.

BANGLADESH



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COUNTRY CONTEXT

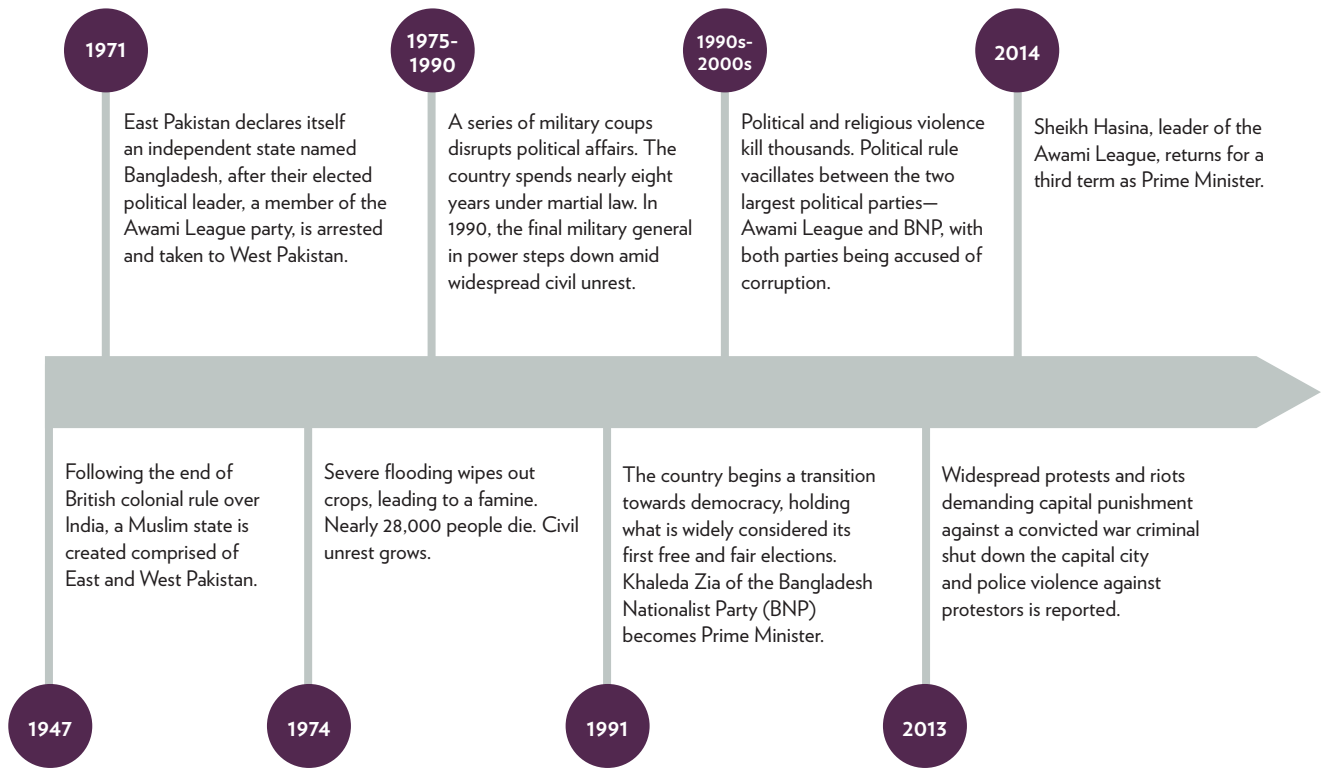
Overview

Bangladesh has the third most active impact investing market in South Asia after India and Pakistan. DFIs have deployed over USD 830 million to date, while other impact investors have deployed USD 120 million.

A number of impact investors are entering South Asia's third-largest economy, encouraged by high economic growth, a large potential market, and an addressable social need. Given that the impact investing industry is still in its early stages, impact investors are pursuing impact through investments in businesses with an impact intent as well as in companies that operate in sectors that investors believe make valuable contributions to the economy and generate jobs. While these trends in capital flow and investor activity are exciting and signal a positive trend, significant challenges remain to grow the industry to its full potential.

Despite many years of instability, violence, and civil unrest ever since Bangladesh's independence in 1971, investors express a belief that the political environment is relatively stable at present. After achieving independence from Pakistan (then called West Pakistan) in 1971, Bangladesh underwent a number of military coups until the final military general in power stepped down in 1990 amid civil unrest. The country has since made a transition toward democracy. While the political system continues to run predictably, there has been widespread political and religious violence since the early 1990s. Most recently, massive protests in response to perceived leniency toward a political figure convicted for war crimes set off riots in Dhaka that soon spread to other cities, and in 2013, labor strikes effectively shut down businesses in the capital. However, there is a widespread belief among local and foreign investors that the country is stable and political transitions will continue to occur peacefully and on schedule due in large part to the generally positive long-term trends in economic growth, foreign direct investment (FDI) inflows, and the stock market growth, despite the decades of political turmoil and civil unrest. In short, the expectation is that business will continue as usual.

FIGURE 1: TIMELINE OF KEY EVENTS IN BANGLADESH'S HISTORY



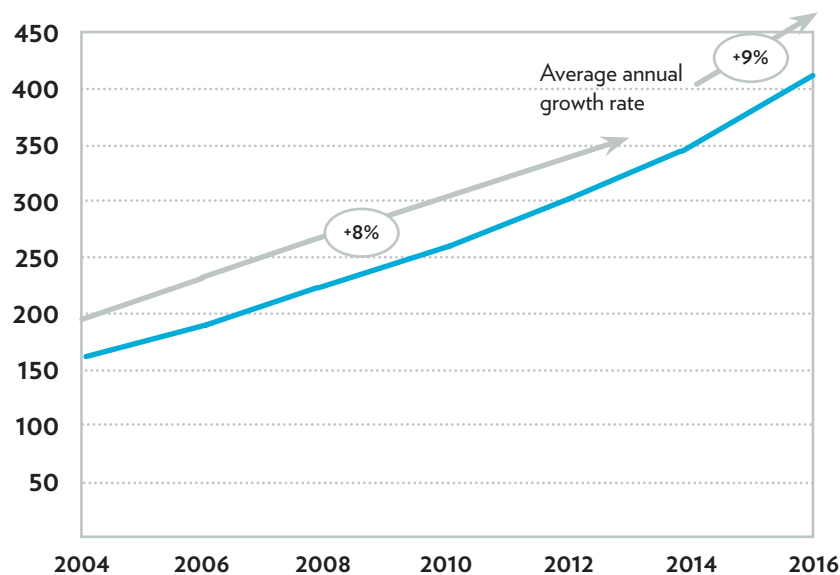
Source: BBC News (2014). Bangladesh profile—Timeline

GDP growth and drivers of FDI

Investors express strong optimism about prospects in Bangladesh, given the country's strong, growing, and diversifying economy and appealing demographic.

In 2013, GDP topped USD 325 billion (PPP, current international dollars), making it the third-largest economy in South Asia.¹¹ Growth has averaged 8% annually in the last decade (through 2013) and is forecasted to continue increasing at 9% annually through 2016.¹²

FIGURE 2: HISTORICAL AND FORECASTED GDP GROWTH (PPP, CURRENT INTERNATIONAL DOLLAR BILLIONS)



Source: IMF World Economic Outlook Data 2014; Notes: 1990-2012 actual, 2013 estimated, 2014-2016 forecasted as of June 30, 2014

This growth has been primarily spurred by a diversification of the economy within the industry and the service sectors. While agriculture, industry,¹³ and services have all grown in absolute terms, agriculture has shrunk in terms of the percentage of value added to the GDP, from 26% of GDP in 1995 to 18% in 2012.¹⁴

A strong services sector and growing industry sector have outpaced growth in the agriculture sector, with the expansion and diversification of the sub-sectors within each sector. Most notably, manufacturing, which is captured in the industry sector, is a booming segment, due to a large and expanding textile and garment industry. Manufacturing alone contributed 18% to the GDP in 2012, up from 15% in 1995.¹⁵

11 IMF World Economic Outlook Data 2014.

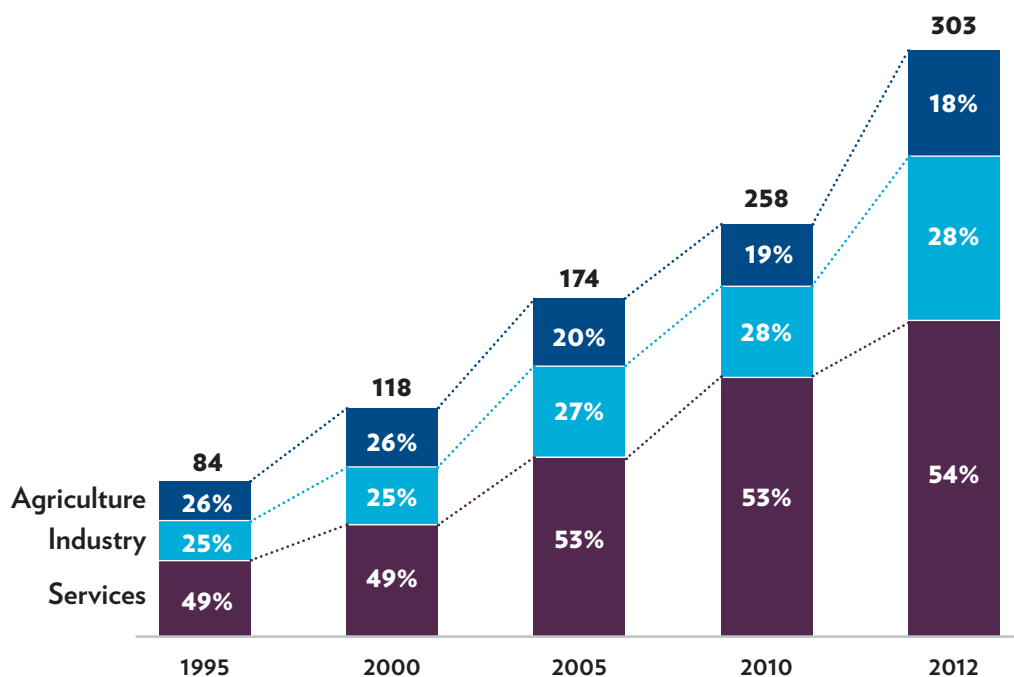
12 IMF World Economic Outlook Data 2014.

13 Industry defined by the United Nations' International Standard Industrial Classification of All Economic Activities, Rev.3 (ISIC Rev 3) as mining, manufacturing, construction, electricity, water, and gas.

14 World Development Indicators, The World Bank.

15 World Development Indicators, The World Bank.

FIGURE 3: SECTOR GROWTH AS PERCENTAGE OF GDP (PPP CURRENT INTERNATIONAL DOLLAR BILLIONS)



Source: World Development Indicators, The World Bank

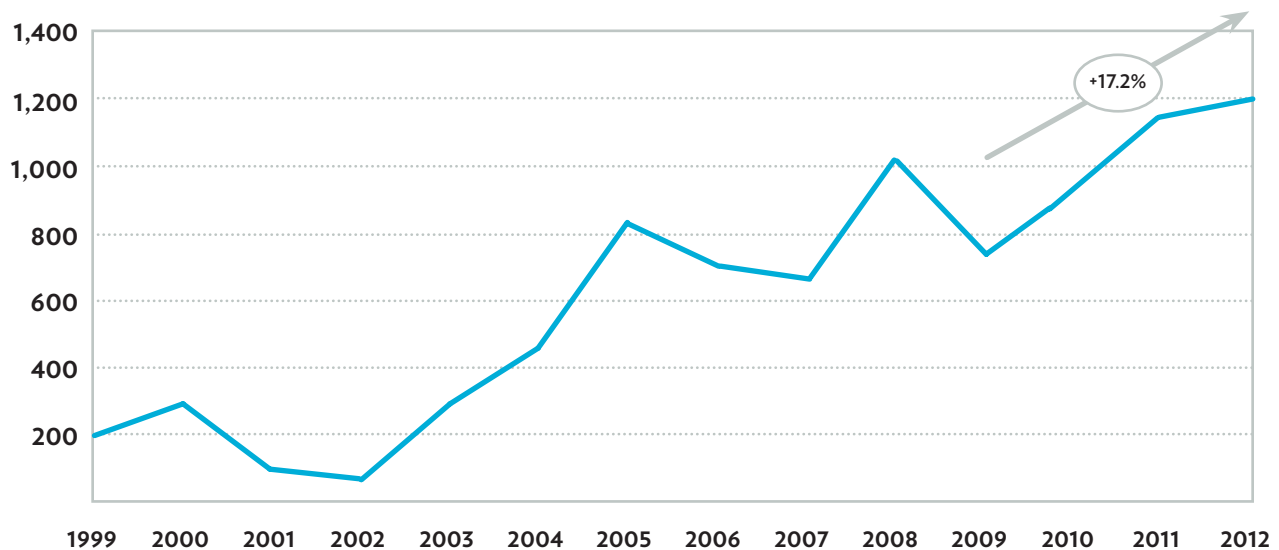
Additionally, Bangladesh’s large population and shifting demographics make the country appealing to investors as both a sizeable labor market and a large potential consumer market.

Bangladesh is the eighth most populous country in the world with a total population of 157 million.¹⁶ The population is relatively young—89% of the people are under the age of 54 years, and 45% are under the age of 24 years.¹⁷ For investors, Bangladesh’s large young population translates into a large potential labor market. There were more than 76 million economically active people as of 2012,¹⁸ and nearly 50 million more will be added in the next decade. Yet, despite significant economic growth in labor-intensive sectors (like manufacturing and agriculture), unemployment remains high, particularly among the youth. As of 2012, 9.3% of the females and 8.6% of the males between 15 and 24 years of age were unemployed; these figures have remained more or less constant since the turn of the century.¹⁹

16 World Development Indicators, The World Bank.
 17 CIA World Fact Book.
 18 ILO Key Indicators of the Labor Market Database.
 19 ILO Key Indicators of the Labor Market Database.

Recent investor optimism has led to sharp increases in FDI inflows since 2009, following a decade of instability, but concerns around infrastructure and policy implementation remain.²⁰ FDI inflows have increased by 17% since 2009 (Figure 4). While foreign investors are responding positively to low labor costs and an increasingly investment-friendly climate shaped by recent policy changes, they have also been discouraged by continuing regulatory uncertainty, which reduces the country's appeal as an investment destination. Investors also cite poor physical infrastructure as a critical limitation and express disillusionment with the actual implementation of investment-friendly policies and the capacity of bodies responsible for enforcing these policies.²¹

FIGURE 4: FDI NET INFLOWS IN CURRENT USD MILLIONS



Source: World Development Indicators, The World Bank

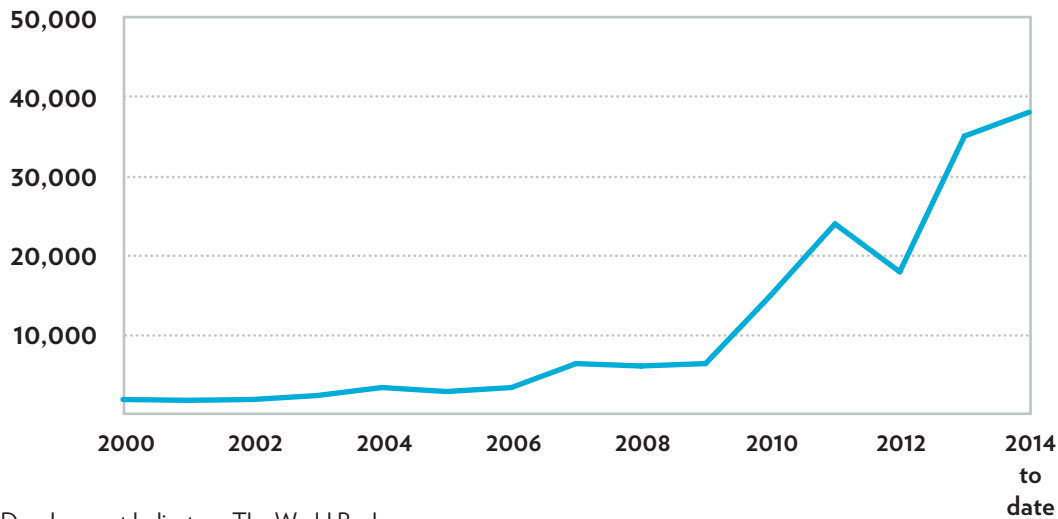
Bangladesh's capital markets are also growing, driven primarily by a developing domestic investment culture. Market capitalization has grown fifteen-fold since 2000.²² Further, there are currently 533 listed companies in the Dhaka Stock Exchange (Figure 5). Following a decade of growth in the stock market averaging about 31% per year from 2000 to 2010, there was a sharp decline in 2011 when capital flowed back toward the developed markets recovering from the 2008 financial crisis. Further drops followed in October and November of the same year, allegedly due to malpractice in the markets, causing public protests and sit-ins by small investors. The market has since recovered, but domestic investors report considerably increased wariness.

²⁰ World Development Indicators, The World Bank.

²¹ Research Center on Development and International Relations (2010). *A Study of Major Determinants and Hindrances of FDI inflow in Bangladesh*.

²² World Development Indicators, The World Bank.

FIGURE 5: MARKET CAPITALIZATION OF LISTED COMPANIES IN USD MILLIONS



Source: World Development Indicators, The World Bank

Despite this growth, investment, and optimism, 43% of Bangladesh's population lives below the poverty line of USD 1.25 per day,²³ although the poverty headcount ratio is on a strong downward trend. Even with a strong and growing GDP, the country has the second-lowest GDP per capita in the region (USD 752, in current USD). For impact investors, the implications are two-fold: i) the poverty headcount translates into a sizeable need and an opportunity to address this need through a range of impact strategies (for example, providing capital to the numerous organizations that deliver goods and services to BoP populations), but for some investors, ii) the high poverty headcount also calls into question the potential in the consumer market and necessitates an approach that reaches those with some disposable income in order to ensure returns.

INVESTING IN BANGLADESH: THE SUPPLY SIDE

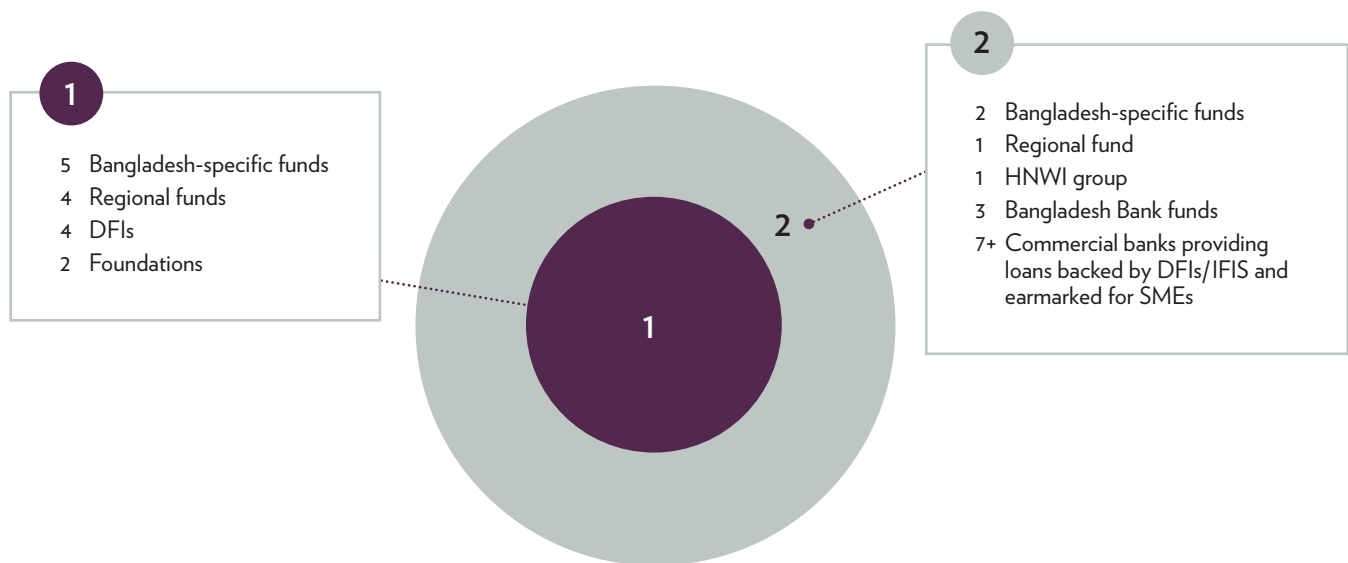
The impact investing market in Bangladesh is nascent, but, of the countries under study, it is the third-most active after India and Pakistan and is likely to continue to see strong growth over the next few years. The Bangladesh market accounts for 11.2% of the total capital deployed among the countries under study, has the fourth-largest number of active players, and has a number of investors scoping the market for possible entry.

²³ The figure of USD 1.25 a day is based on the World Bank's revised poverty line at 2005 purchasing power parity.

The broad impact capital market in Bangladesh

There are at least 15 impact investors currently active in Bangladesh with a total of USD 955 million in deployed capital, of which USD 834 million has been deployed by DFIs.²⁴ Among these investors, there are nine funds (five investing only in Bangladesh and four regionally), four DFIs, and two foundations (Figure 6). These investors currently have more than 50 active investments.²⁵ While most of these investments have been made by a few small private equity funds, the bulk of capital represents investments by DFIs in enterprises and banks and by microfinance institutions (MFIs). The section “Key trends of impact investing in Bangladesh” discusses in detail the emerging trends among these investors.

FIGURE 6: NUMBER OF DIRECT IMPACT AND IMPACT-RELATED INVESTORS ACTIVE IN BANGLADESH



Sources: Stakeholder interviews; Investor websites; Dalberg analysis

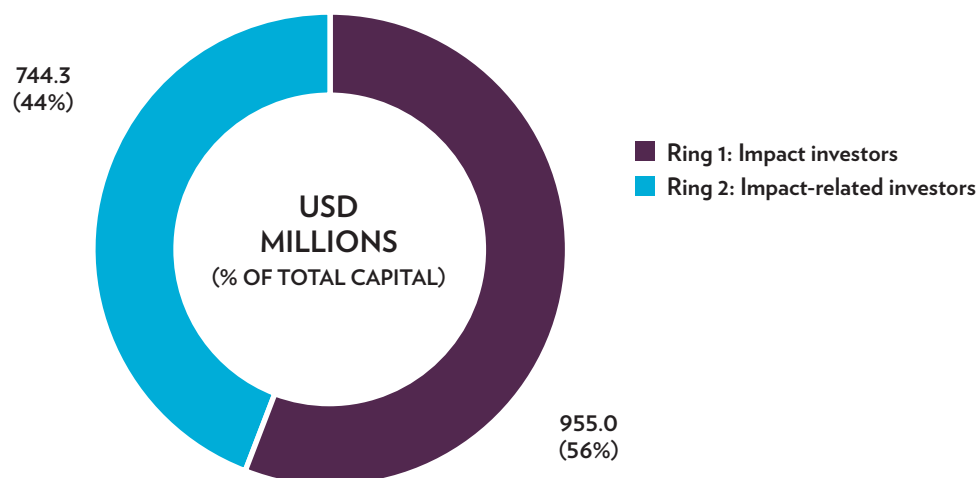
Beyond these impact investors, at least 14 impact-related investors have current investments in Bangladesh of about USD 744 million (Figure 7). Most of this capital has been provided as loans to SMEs through commercial banks. The remaining investors are funds and a small group of high net-worth individuals (HNWIs). While commercial banks have a clear primary focus on financial returns and, for now, see their impact as a by-product of their lending activity, some of these other impact-related investors may develop a more explicitly intentional strategy, as they seek to formalize their impact measurement and articulate clearer non-financial

²⁴ Figures in this report represent a best effort to size the total impact investing market in Bangladesh, including both impact and impact-related investors. While there may be additional investments on the margins that remain uncaptured, these figures provide a directionally accurate estimate of the market.

²⁵ This excludes one outlier, which has more than 2,200 investments; many of these investments are small, microfinance-like investments, while a few are equity investments into SMEs.

objectives. As many of these investors have focused on gaining a foothold in the market and achieving financial sustainability, impact intention has not been a core focus to date, but this is likely to become clearer over time.

FIGURE 7: TOTAL CAPITAL DEPLOYED BY RING, BANGLADESH



Sources: Stakeholder interviews; Investor websites; Dalberg analysis

Investors of the same type (DFIs, foundations, etc.) are largely concentrated within the same ring, with the exception of fund managers that appear in both rings. All DFIs and both foundations are impact investors, whereas commercial banks, three Bangladesh Bank funds, and one group of HNWI are impact-related. There is more diversity among fund managers, which are found in both rings.²⁶

Active impact and impact-related investors in Bangladesh

We see a diverse range of investors operating in Bangladesh. A range of players are active in Bangladesh as either impact or impact-related investors, including funds, DFIs, foundations, HNWI and family offices, diversified financial institutions and banks, and the Bangladesh Bank, which, while being primarily the country's central bank, also manages three funds.

Funds are the most common type of investor currently. There are 12 active funds in Bangladesh—seven of these funds are only making investments in Bangladesh, while the remaining five are regional with capital deployed in other countries. Ten of the 12 are private equity (PE) funds and two are venture capital (VC) funds. PE funds are backed by a range of limited partners (LPs), mostly DFIs but also foundations,

²⁶ The Bangladesh Bank operates three programs that provide subsidized debt to banks for SME lending: The Equity and Entrepreneurship Fund (EEF), JICA-SME Loans, and ADB Refinance Scheme.

HNWIs, and family offices. The three VC funds are investing off their own books with capital invested by the general partners. Of these funds, nine are impact investment funds while three are impact-related but invest in relevant markets.

DFIs are responsible for the largest portion of impact capital through investments directly in enterprises. Currently, four DFIs have nearly USD 834 million of investments in enterprises, primarily in information and communication technology (ICT),²⁷ energy, manufacturing, financial services, and agro-processing. DFI investments account for 87% of the capital deployed from impact investors. Details on DFI investment preferences are discussed further in the section “Key trends of impact investing in Bangladesh.”

DFIs (and one multilateral donor) have also provided USD 739 million in debt and guarantees to banks for SME²⁸ loans. An industry-wide liquidity crisis in 2011²⁹ prompted four DFIs to provide capital to seven banks, earmarked for SME loans. One DFI and one bilateral donor have also provided funding to the Bangladesh Bank for SME lending through commercial banks, and an estimated USD 153 million has been loaned through these funds.

About 94% of the capital originates with DFIs through their direct investments into enterprises, guarantees, and indirect investments (anchoring funds and backing commercial SME loans), and given this sizeable role in the impact investing market, DFIs are driving trends across the space. The significance of DFIs is twofold: i) as a vital and significant source of capital for enterprises and funds and ii) as a catalyzing force signaling the potential of the market and the credibility of local enterprises and fund managers. In an effort to draw in other investors, DFIs often back funds as anchor investors. In some cases, DFIs have succeeded in catalyzing as much investment from other investors as they themselves have put in. In others, investors have chosen to wait to observe some fund investment activity before making a commitment. While it is difficult to demonstrate the catalytic effect of DFIs at this stage since the industry is so new, we do see fund managers actively seek DFI anchor participation for both these reasons. However, the fact that some funds with DFI commitments have been unable to raise matching capital, suggests that DFI participation alone is not sufficient. More broadly, prospective investors are also waiting to observe a stronger track record of exits before entering the market.

DFIs are also driving trends beyond capital, often setting benchmarks for defining and measuring impact and advocating pro-investment policies. Many trends in the placement of capital discussed in depth throughout the Bangladesh report are driven by the substantial DFI spending, but investors are also looking to DFIs for impact definitions and measurement standards. In Bangladesh, DFIs have

27 ICT includes information technology companies (e.g., internet service providers and software developers) and communication technology companies (e.g., mobile network providers).

28 SMEs are defined by the Bank of Bangladesh as follows: (i) not publicly listed and (ii) 10–100 employees and fixed assets of USD 6,400–1.9 million for trading and services or 25–250 employees and fixed assets of USD 64,000–3.9 million for manufacturing.

29 In late 2010, the Central Bank moved to address inflation and reign in financial markets by raising the cash reserve ratio of banks and asking financial institutions to adjust their stock investment exposure. The move heavily reduced liquidity in the banking sector, and in part, contributed to the stock market crash in 2011.

identified job creation and economic growth as core impact goals, and this has led them to focus their activities on high-growth sectors. DFIs are also using their legitimacy to advocate for pro-investment policy changes within the government. For example, one DFI is working with policymakers to address the lack of understanding about venture capital and private equity in order to develop stronger regulatory frameworks that make Bangladesh more appealing to both PE and VC investors. DFIs have also been advocating for the loosening of a three-year lock-in period for investors following an initial public offering (IPO).³⁰

Only two foundations are currently active as investors, but foundations are also providing business development services. While only one domestic foundation is providing debt financing to SMEs and one international foundation has made an equity investment, foundations have been active in offering technical assistance to business managers, discussed further in the section “*Enabling impact investing: The ecosystem.*”

HNWIs are likely a large source of start-up capital, most of which is provided informally; foreign HNWIs have backed a few funds, and at least two family offices are scoping the market. Family and friends are the primary source of seed capital for young entrepreneurs. A number of successful Bangladeshi entrepreneurs have also provided start-up capital. In most cases, these investments are made without any formal documentation or set timelines, and due to their informality, it is difficult to scope the exact size of this market. However, most players in the market estimate this capital to be substantial. Beyond this, only a few formal domestic HNWIs offer capital as angel investors. Foreign HNWIs have backed impact funds, but typically in small amounts. At least two foreign family offices have been in talks to back a local fund.

Institutional investors largely operate on a commercial basis as lenders, but seven banks have portfolios targeting lending to SMEs and women-owned enterprises. Seven banks have received capital from DFIs that has been earmarked for SME lending. Banks are also lending to SMEs in priority sectors driven by government mandate rather than by impact intention.

³⁰ The Securities and Exchange Commission mandates that “the securities (equity share) subscribed by the Sponsors/Promoters/Directors as described in the Prospectus, shall be subject to a lock-in period as under: ‘Three years in case of Companies intended/intending to go for Initial Public Offering (IPO) from the date of its approval thereof by the Commission or from the start of its commercial operation, whichever is later.’ There will be no lock-in on foreign sponsors.”

FIGURE 8: TYPES OF IMPACT AND IMPACT-RELATED INVESTORS ACTIVE IN BANGLADESH

TYPE OF INVESTOR	ESTIMATED NUMBER	DETAILS OF INVESTORS IN BANGLADESH
Funds and fund managers	12	Ten private equity funds and two venture capital funds testing the market with equity and quasi-equity investments
DFIs	4 DFIs and one donor	Drivers of market trends through both large, direct investments into enterprises (mostly debt to mature stage companies), as well as indirect investments (acting as LPs of funds or providing debt capital to banks for SME lending)
Foundations	2	Limited number of players in the impact investment market— one providing small amounts of debt financing to SMEs and one that has made an equity investment—but more active as business development providers
HNWIs/Family offices	5-10 formal and many more informal	Friends and family are likely one of the largest sources of seed funding, but most of these investments are made informally—with no documentation or timelines. Only a small number of HNWIs offering capital beyond this—as LPs or making direct investments—and at least two family offices looking to back a fund.
Diversified financial institutions/banks	7+	Seven banks lending to SMEs with debt provided by DFIs
Bangladesh Bank (central bank of Bangladesh)	3 funds	Managing three funds providing subsidized debt to banks making SME loans to targeted sectors or disadvantaged groups

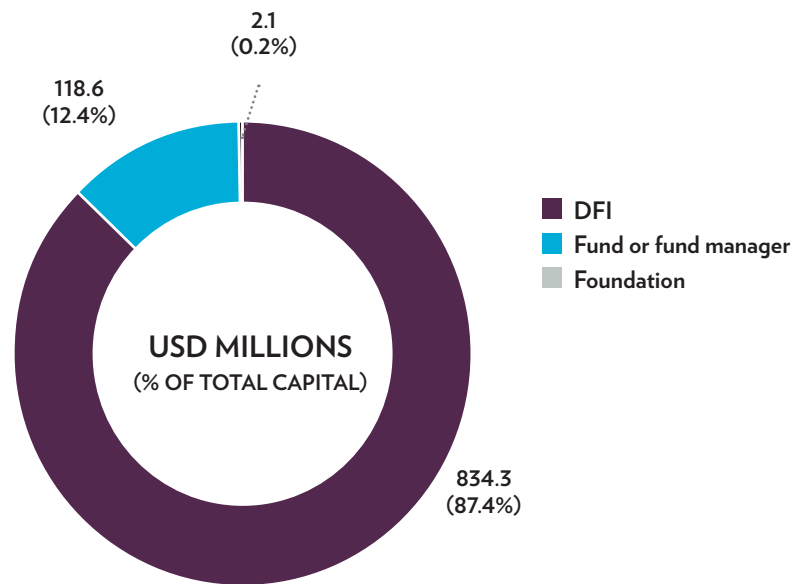
Key trends of impact investing in Bangladesh

The following section examines trends among impact investors, the “core” ring of investors under study. The figures quoted in this section refer only to this set of investors, who collectively have about USD 955 million currently deployed. The activities of impact-related investors will be discussed in the section “Beyond the impact investing market.” Given the sizable amount of capital deployed in Bangladesh, we see interesting trends emerging around impact investor preferences in terms of instrument, growth stage and deal size, and sector.

INVESTOR MIX

Among all the known impact investors, DFIs have deployed the largest amount of impact capital into enterprises. About 87% of the capital is deployed by DFIs. The remaining 13% has been deployed by fund managers and foundations.

FIGURE 9: IMPACT CAPITAL DEPLOYED DIRECTLY BY TYPE OF INVESTOR (USD MILLIONS)

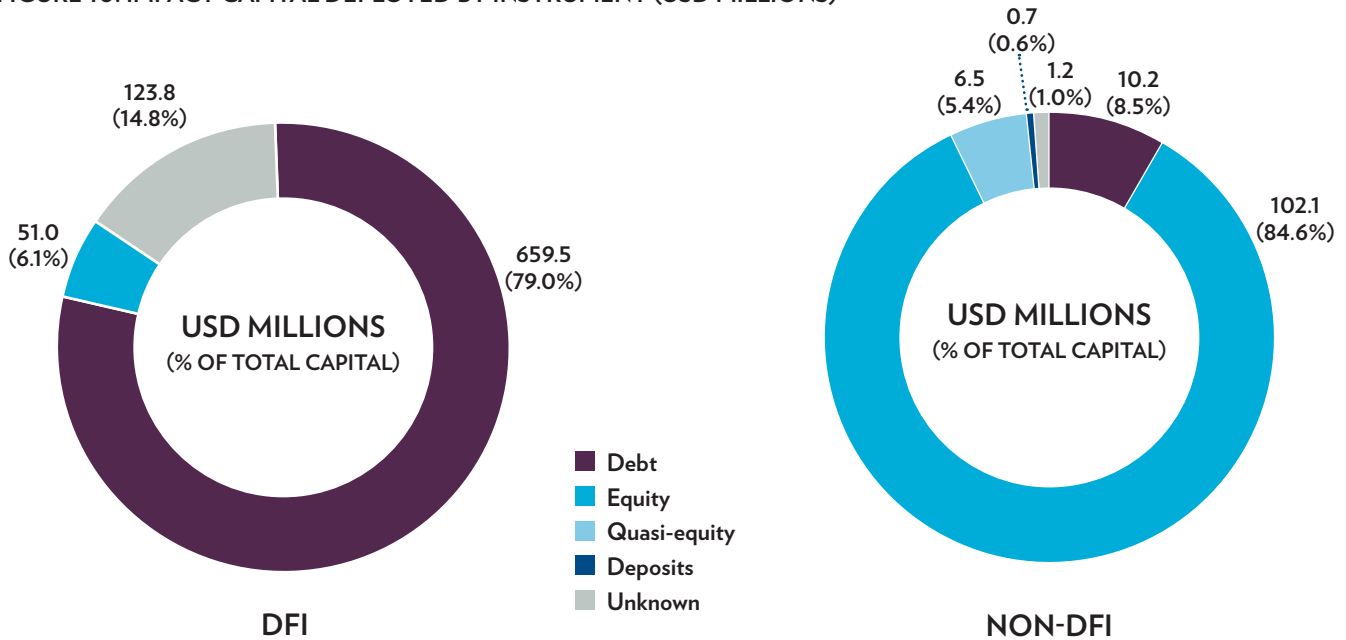


Sources: Stakeholder interviews; Investor websites; Dalberg analysis

INSTRUMENT

Seventy percent of the total impact capital currently deployed has been through debt. The overall trend can largely be explained by the sizeable amount of capital flowing from DFIs. As we see in Figure 10, 79% of the USD 834 million invested by DFIs is through debt. This preference for debt is driven by risk aversion, regulatory barriers for using other instruments, and a greater familiarity with debt (particularly among business managers). In contrast, only about 9%, or USD 10 million, of capital from non-DFIs is structured as debt.

FIGURE 10: IMPACT CAPITAL DEPLOYED BY INSTRUMENT (USD MILLIONS)



Sources: Stakeholder interviews; Investor websites; Dalberg analysis

Equity and other instruments are being tested in small amounts by all types of investors, but are the most common type of instruments for non-DFI investors.

Instruments other than debt make up about 17% of the known capital among impact investors. As seen in Figure 10, equity is the most common instrument used, outside of debt. While DFIs have made equity investments worth USD 51 million (or about 6% of their investments by value), it is the non-DFI investors that are primarily exploring instruments beyond debt. About 91% of the non-DFI capital has been deployed through equity, quasi-equity, or deposits. This is largely driven by a single large domestic fund that has made nearly USD 100 million in equity investments.

In general, both investors and entrepreneurs express that debt is preferable given their needs and expectations.

Investors, unsurprisingly, are looking to minimize their risks in the nascent impact investing market of Bangladesh, and debt allows them to assume less risk than other instruments. While one may expect early and growth stage entrepreneurs to seek equity investments, as these are often appropriate for their stage of growth, entrepreneurs tend to be more familiar and comfortable with debt structures and are reluctant to give up stake in their company. Many business owners do not recognize the value of instruments beyond debt and are unaware of the risk mitigation that equity structures can allow.

Regulatory structures surrounding equity investments, particularly those around exits and legal protection of the investor and investee, also fuel the preference for debt.

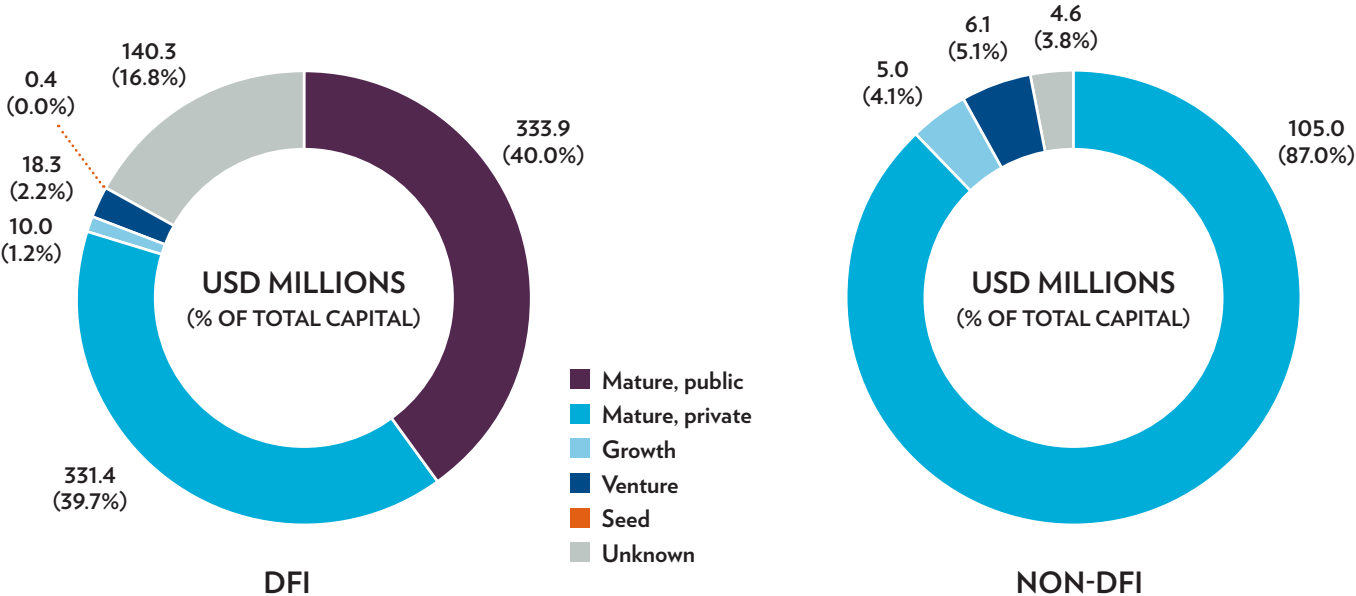
The regulatory process for exits through IPO is unclear, and investors face a three-year lock-in of their investment following a public listing. Investors and investees are also uncertain of the legal framework for addressing disputes that might arise.

GROWTH STAGE AND DEAL SIZE

Mature companies have received most of the known capital, as these companies can absorb larger amounts and meet the operating requirements of the investors.

Mature companies are attracting most of the capital from both DFIs and non-DFI investors for two reasons. First, only mature companies are of a size capable of absorbing the amount of capital that many impact investors look to invest in deals, i.e., typically more than USD 1 million. Second, mature companies have an established operating history, are legally registered, and keep (at least partially) accurate financial records—all important requirements for investors. However, there is some concern that the pipeline of attractive opportunities in mature companies is limited. Investors scoping the market have suggested that the few large funds operating in Bangladesh have already taken the “low hanging fruit” of desirable investments, and hence, impact investors, finding it more difficult to secure investments in mature companies, are expected to begin exploring investments in earlier growth stages. Further, as VC funds continue to explore the market, it is likely that capital will be more diversified across different business stages.

FIGURE 11: IMPACT CAPITAL DEPLOYED BY GROWTH STAGE (USD MILLIONS)



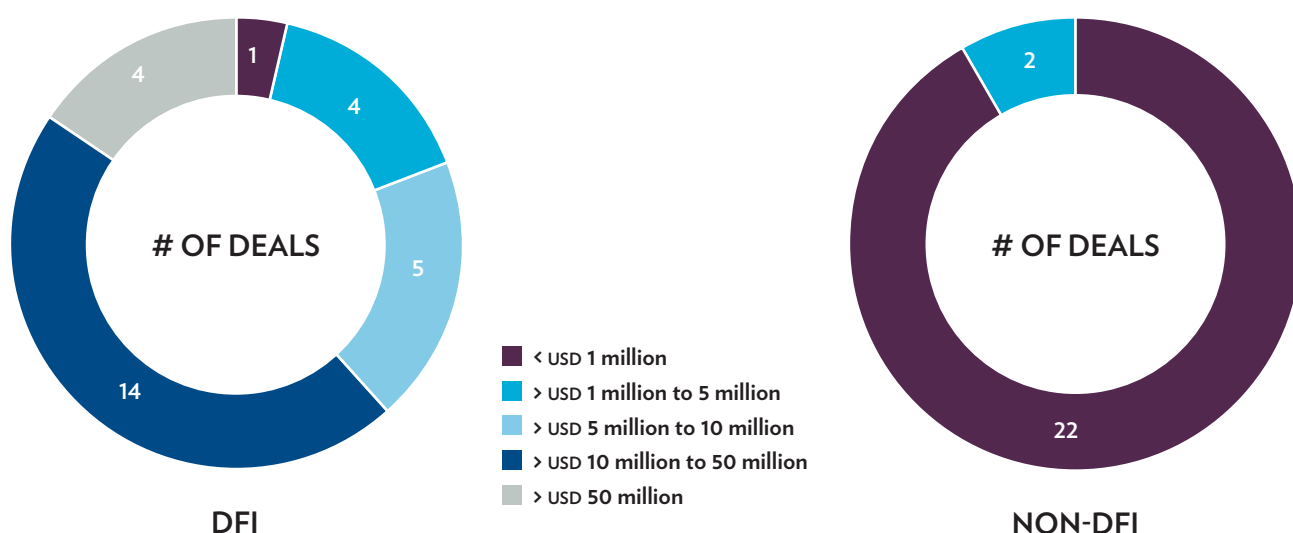
Sources: Stakeholder interviews; Investor websites; Dalberg analysis

While seed funding is nearly negligible as a share of the total capital deployed through formal channels, entrepreneurs with strong networks can raise seed capital from friends and family; those without strong networks struggle to raise seed capital, which is a major gap in the market. Entrepreneurs, finding it difficult to access bank loans (due to high collateral requirements) or to reach other investors, often turn to friends and family for start-up capital. Seed capital needs are often minimal, and for amounts less than USD 10,000, well-connected entrepreneurs can access capital through such informal channels. Given that many young entrepreneurs

are launching start-ups that require minimal capital expenditure, particularly in the ICT sector, informal funding is likely to constitute a significant amount of capital. However, this source of funding is not available to all entrepreneurs; thus, a gap still exists for some entrepreneurs looking for seed funding.

Venture and growth stage funding represent the largest gaps. For growth and venture stage companies looking for capital in the range of USD 50,000 to USD 1 million, accessing capital is a significant challenge. These challenges will be discussed later in the section titled “Challenges facing investors deploying impact capital in Bangladesh.”

FIGURE 12: IMPACT CAPITAL BY DEAL SIZE (USD MILLIONS)



Sources: Stakeholder interviews; Investor websites; Dalberg analysis . Notes: This excludes one outlier, which has more than 2,200 investments; many of these investments are small, microfinance-like investments, while a few are equity investments into SMEs.

There have been about 50 investments to date, of which about half have been less than USD 1 million in size, reflecting the small portfolio sizes of the non-DFI investors and the capital needs of the target investees. As seen in Figure 12, DFI deals have been typically at the larger end; only one DFI deal has been less than USD 1 million, while 18 have been greater than USD 10 million. Meanwhile, 22 out of 24 non-DFI deals have been less than USD 1 million. Although not presented in the above chart, it is worth highlighting that one local impact fund has made 2,245 investments in small enterprises that can only absorb small amounts in the range of USD 30,000.

Deal size is largely dependent on sector—most ICT companies look for relatively small investments, whereas manufacturing tends to require more capital. With the exception of one large phone company, most enterprises in the ICT sector are small and looking for a corresponding amount of capital. Thus, relatively small funds are investing in these companies.

SECTOR

The sectors receiving most of the impact investing capital are high-growth sectors such as ICT, manufacturing, and energy. Investor confidence in these sectors is high due to strong historical performance and future growth prospects. Both ICT and energy have been identified as government thrust sectors, further driving interest in these areas. The high-growth sectors are appealing because of their potential to both provide financial returns and help meet the investors' impact goals, as these sectors are likely to generate jobs and stimulate economic growth (which, as will be described later, have been identified by DFIs as the core impact objectives).

Financial services and microfinance are also receiving a small portion of capital from both DFIs and funds. Bangladesh is the birthplace of the microfinance movement³¹ and has seen a large number of organizations grow to a large scale over the past three decades. Foreign investors have expressed that the MFI market is rather saturated, so we see few direct investments in these sectors. However, DFIs are providing guarantees and debt to lending institutions—including banks and some of the country's largest MFIs—in an effort to increase SME access to finance that is often constrained. In other words, in Bangladesh, DFIs are using MFIs and other banks as vehicles for SME lending; this activity is being captured as “Ring 2” investments, as loans from banks and MFIs to SMEs. This is further discussed in the “Beyond the impact investing market” section.

Exit possibilities

Investors express a preference for IPO exit, and optimism is growing regarding the viability of this exit strategy as one impact investor is approaching an IPO with a current investment. IPOs are favored as they are perceived to yield the highest returns. To date, no impact investor has exited an investment through an IPO, so investors are watching with tempered optimism as the first impact investment is moving through a public listing. The process for IPO is long (typically a year) as the exact process is unclear and can change from investment to investment. Therefore, investors—particularly domestic investors—expressed interest in the outcome of the first impact investment being exited through public listing.

While IPO is the preferred exit, secondary sales, trade sales, and owner buyback are all viewed as feasible exit options. Because of the difficulties associated with IPO exits—including long lock-in periods and an uncertain process—investors have instead exited investments through secondary sales, trade sales, and owner buybacks, and they believe that these avenues remain feasible options for exiting investments going forward as well.

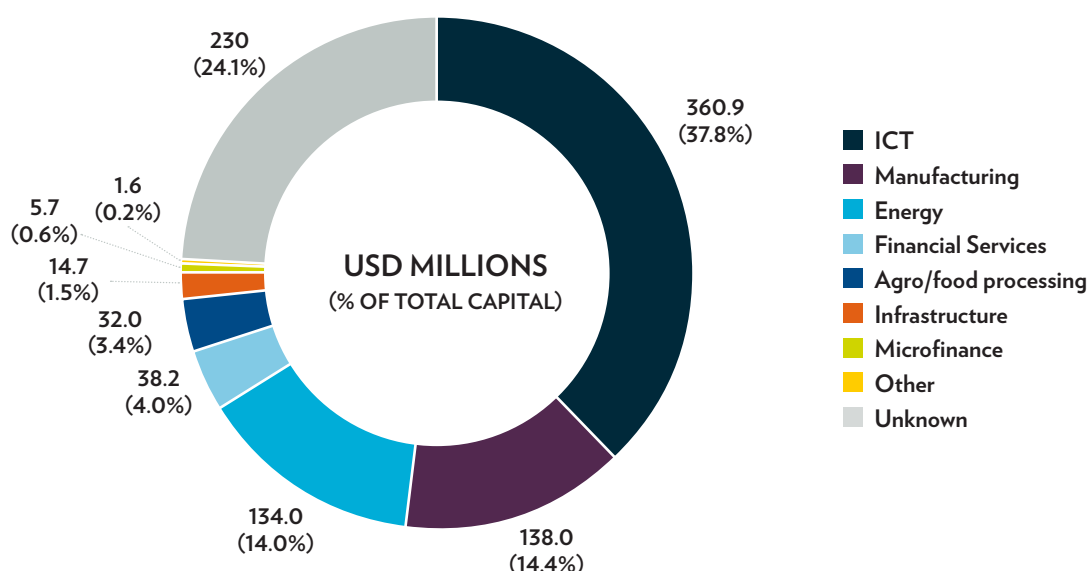
³¹ While microcredit existed informally prior to the 1970s, Professor Muhammad Yunus is widely credited as bringing microfinance to the global stage. Yunus began making informal loans in the 1970s and started Grameen Bank in 1983. Grameen Bank, along with a Bangladesh-based non-profit BRAC, are now two of the largest microfinance institutions in the world by number of borrowers.

Impact measurement

Of the 15 impact investors active in Bangladesh, at least four DFIs and six funds have reasonably well-developed impact metrics that are measured and reported.

DFIs typically define impact in the context of Bangladesh as “job creation,” with additional metrics in place to ensure ESG compliance. Fund managers typically follow DFI standards for measuring and reporting impact, given that DFIs act as LPs for some funds (and thus, require specific reporting of metrics) and because DFIs are the most active players in this field. The preference for ESG compliance is also driven by widespread availability of ESG metrics and recognition that ESG compliance

FIGURE 13: IMPACT CAPITAL DEPLOYED BY SECTOR (USD MILLIONS)



Sources: Stakeholder interviews; Investor websites; Dalberg analysis. Note: Approximately USD 104 of USD 120 million of non-DFI investments are unknown with respect to sector, and therefore the above graph largely represents trends of DFI investors.

satisfies basic “impact” criteria and mitigates the risk of non-compliance for investor and investee. Nevertheless, in some cases, investors are further customizing metrics to look beyond ESG compliance, measure more relevant indicators, and reduce the reporting burden for the investees. For example, these metrics include “the number of products sold to poor households,” “the number of poor households reached per USD 100,000 of investment,” and “the estimated trade generated (in USD).” The metrics selected are case specific (dependent on the type of enterprise and intended impact).

Outside of these 10 organizations, and outside of ESG metrics, most investors provide anecdotal reporting of the impact. Impact measurement is considered secondary to managing the investment, which, in the context of Bangladesh, requires a large investment of time and resources on the part of the investor. As a result, many investors have limited capacity to define metrics and measure non-financial performance, and therefore either focus on more limited metrics, are still working to develop appropriate metrics, or report only anecdotally. These investors believe

impact measurement is important and intend to develop more formal processes and metrics based on standardized approaches once they have sufficient capacity to do so.

Beyond the impact investing market

The most active investors on the periphery of impact investing are commercial banks lending to SMEs. About USD 731 million, or 98% of the capital deployed by this ring, is commercial bank lending to SMEs with capital from DFIs and one bilateral donor. While information on the individual portfolios of these banks is not publicly available, the following trends can be summarized:

- All of this capital has been deployed as debt to SMEs.
- Growth stage preference depends on the lender, but as the banks require at least a few years of operating history to qualify an entity for a loan, there is mostly no seed funding and minimal venture stage funding.
- Sector preferences depend on the lender, but most lending is sector agnostic. However, preference may be given to government thrust sectors and women-owned enterprises.
- As these funds target SMEs, deal sizes are likely to be less than USD 1 million.

Beyond SME lending, three impact-related funds and one group of HNWIs are providing small amounts of equity and deposits. In total, these investors have USD 14 million in active investments—41% as equity and 59% as deposits—with deals ranging from USD 36,000 to USD 5 million. While the growth stage is unknown for most of this capital (61%), we see about USD 500,000 invested in venture stage organizations and USD 5 million in mature private enterprises. Investments have flowed into a number of sectors. Health has received the largest segment of capital from these investors (USD 5 million); however, this is the result of a single, relatively large investment. Beyond health, these investors, like impact investors, prefer high-growth sectors. Agro/food processing, manufacturing, ICT, and agriculture have absorbed 52% of the capital from these investors, and the remaining capital has been spread across a diverse range of sectors in small amounts.

Challenges facing investors deploying impact capital in Bangladesh

While impact investors are fairly optimistic about Bangladesh due to political stability, GDP growth, and demographic trends, there are still significant challenges that dissuade investors from entering the market.

FIGURE 14: CHALLENGES FACED BY INVESTORS AND ASSET MANAGERS ACROSS THE INVESTMENT CYCLE



Severity of investor challenges, by stage of investment



Key challenges faced by investors and severity of impact

Difficulty in raising funds	Difficulty identifying potential investees—largely network driven	Companies reluctant to register as LLC in order to qualify for investment	Companies want small investment, cannot absorb large capital	Investees reluctant to use capital to grow; instead see it as a rainy day fund	Difficulty repatriating investment
Difficulty in finding local talent to manage fund	Small number of desirable companies; early entrants have taken "low hanging fruit"	Companies often lacking accurate or sufficient financial records, unwilling to share financials	Mismatch between investor and investee expectations; investor expects controlling share	Unclear investor protection laws; uncertainty about legal recourse in case of contract default	IPO exit process not defined, no clear regulations and long lock in periods
Limitations for local funds; many investors set up overseas fund					



Sources: Stakeholder interviews; Dalberg analysis

For asset managers, the key challenges at the entry stage have been the difficulty in raising funds and the regulatory limitations surrounding domiciliation. Nearly all Bangladesh-specific funds have had difficulty in raising capital, with only one fund successfully closing after meeting its target. Most fund managers would like DFIs to act as LPs, with seven of the eight funds (six active and two scoping) currently or previously approaching DFIs for funding. While DFIs have backed two funds and committed capital to others scoping the market, securing additional co-investors has been a challenge for fund managers. A part of this challenge has been scale; DFIs typically require their investment to be both fairly large (e.g., USD 20 million) and only a portion of the total fund (usually 25%–30%). Therefore, large amounts of additional capital need to be raised, but this has proved challenging. Only one fund has successfully raised its target capital, with many others closing well below their targets and some unable to raise sufficient capital to launch the fund. A suggested reason for the difficulty in raising funds is that LPs are waiting for one large fund to exit a few deals before committing, in order to better gauge the market.

In addition to difficulties in raising funds, fund managers face regulatory issues around both overseas and domestic domiciliation of equity funds. Because regulations limit access to foreign capital for companies that are not appropriately registered to accept foreign capital, investing out of foreign-domiciled funds can be challenging as it limits the potential of the investment pipeline. This leads fund managers to see the need to domicile in Bangladesh. However, domiciling in Bangladesh can be a long process,

particularly for funds with foreign LPs, and given that there is no explicit option to structure and register a fund locally, domestic funds often have to go through the process of registering as a private company.

While pipeline development is a challenge, issues can be overcome if investors (whether asset owners or fund managers) can develop networks and establish a local presence. Early funds have taken the “low-hanging fruit” in the market, as only a few companies are currently structured and registered appropriately for investment. As a result, fund managers must invest quite a bit of time scoping for investment opportunities. This is particularly true for those with small portfolios, as they can only make small deals and finding investable companies of this size requires a heavy investment of time. While this creates an additional barrier for investing, it is not insurmountable. Many fund managers have started developing a local presence, and partnerships are developing across funds to leverage strong networks.

Screening companies and structuring these companies for investment represent the largest challenges facing investors, particularly equity investors. Many companies in Bangladesh lack strong governance and financials that are accessible and sufficiently accurate to structure a deal. Companies are often run as traditional family businesses, operating with multiple financial accounting records—one for tax purposes and another that is more accurate. For investors, a large amount of time and resources must be devoted to working with business managers to set up governance structures and create financial records prior to making any investment. Even more difficult, investors have to convince business managers of the value of equity, as most are unfamiliar with the instrument, are unwilling to dilute their ownership, or do not want to legally register as a corporation in order to accept equity. Therefore, business managers prefer debt.

Screening and due diligence are less challenging for debt investors because there are more safety mechanisms in place, including credit rating agencies to evaluate risks.

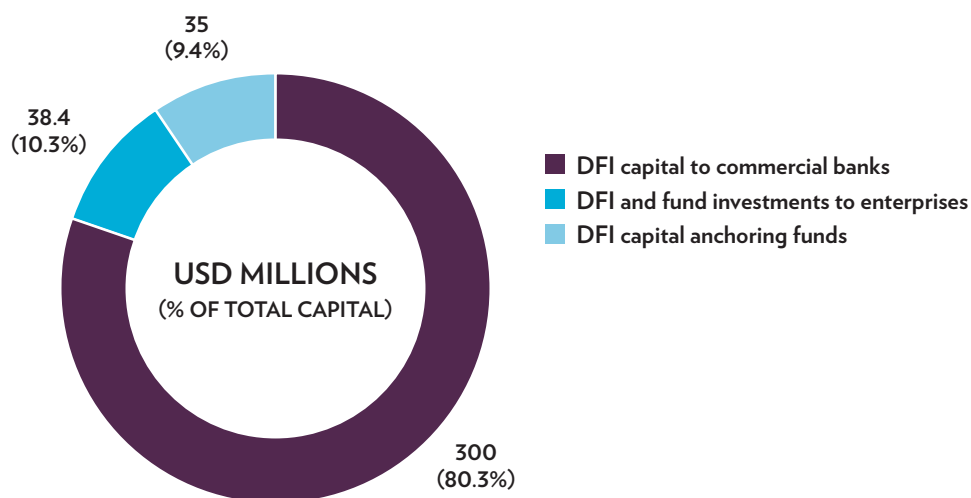
Although uncertainty around exits makes it difficult for some asset managers to raise funds, active investors have not been deterred by exit uncertainty. All equity investors expressed a preference for exit through IPO. They expect the greatest returns from public listing and are most familiar with this mechanism. Investors express hope that IPOs will be a viable option at the end of their investment periods, but believe that other options may be more feasible, such as owner buy-back and trade sales. Secondary sales are rare due to a limited number of senior funds.

To date, no equity investments have gone through an IPO process, so while IPOs are the preferred exit among equity investors, it is uncharted territory. IPOs are not common due to unclear and somewhat unfavorable regulations regarding the IPO process. For example, long lock-in periods imply that equity investors cannot sell their shares immediately after listing, increasing their time horizon and potentially lowering their returns. Additionally, despite open repatriation policies on paper, in practice, investors have found the process to be quite challenging. That said, there has been active engagement of the investors and donors with the government and the regulators to identify such challenges, and there is a strong perception that there is commitment to reform and develop a more conducive framework for capital investors.

Looking forward

The landscape for impact investing is evolving. Active investors have already committed additional capital (beyond what has been deployed), funds are raising capital, and impact definitions are becoming more sophisticated.

FIGURE 15: FUNDS COMMITTED BUT NOT DEPLOYED



Sources: Stakeholder interviews; Investor websites; Dalberg analysis

Investor optimism is evident, with an additional USD 373 million committed but not yet deployed by impact investors and others on the periphery of impact investing. About USD 300 million of the USD 373 million has been committed to commercial banks for SME lending. About USD 38 million has been committed by direct investors—five investments in companies by an existing fund and direct investments in a hospital and a power plant.

Fund managers are looking to raise capital and are confident that they will be successful. At least four fund managers are looking to raise a combined total of USD 750 million. A few funds have even hired local fund managers before the fund closes, expressing confidence that capital will be raised and an eagerness to begin sourcing deals.

Additionally, there are expectations that local government bodies will be allocating more capital for SMEs. The government has identified SMEs as a focus area for financial and technical support. As such, it is expected that the government will be launching new financing schemes for SMEs, but few details are known.

The types of investors present are expected to diversify as the market evolves. Although still nascent, more players active in the impact investing market recognize that Bangladesh is at an inflection point. While investors to date have primarily been DFIs, commercial banks/non-bank financial institutions (NBFIs), and small funds,

there are expectations that the space is on the brink of diversification. In fact, new venture capital firms and angel investors are already emerging, all of them local with small portfolio sizes.

Investors scoping but not yet active in the market are waiting for the two largest funds to fully deploy and for a few successful exits before entering the market.

A number of foreign investors interested in the country expressed that while they are enthusiastic about the potential of the market, they are waiting for the currently active impact investors to test and prove this potential. As discussed previously, one fund is currently in the process of an IPO exit, and the outcome will be a critical moment for impact investors.

At the early stage of the market's development, the threshold for "impact" is still unclear, but it is expected that measurement and intention will become more sophisticated as impact investors become more targeted in their portfolios.

To date, investors have been primarily looking to DFIs to take the lead on defining impact, as DFIs are both LPs for funds (and thus, have specific measurement and reporting requirements) and early movers with an articulated impact thesis. As a result, in Bangladesh, "impact" is largely defined in terms of job creation. This is a relatively easy metric to measure and requires little customization. However, as impact investors become more established, many want to identify metrics that use a broader set of indicators specific to the sector and the expected impact of the investment. For instance, one fund manager expressed that their focus to date had been on financial returns with the investor himself dedicating all his time and resources to mentoring entrepreneurs, leaving no time for thinking through impact definition or measurement. However, this investor is now looking for strong examples of impact measurement and reporting to incorporate into his investing activities.

NEEDS AND OPPORTUNITIES: THE DEMAND SIDE

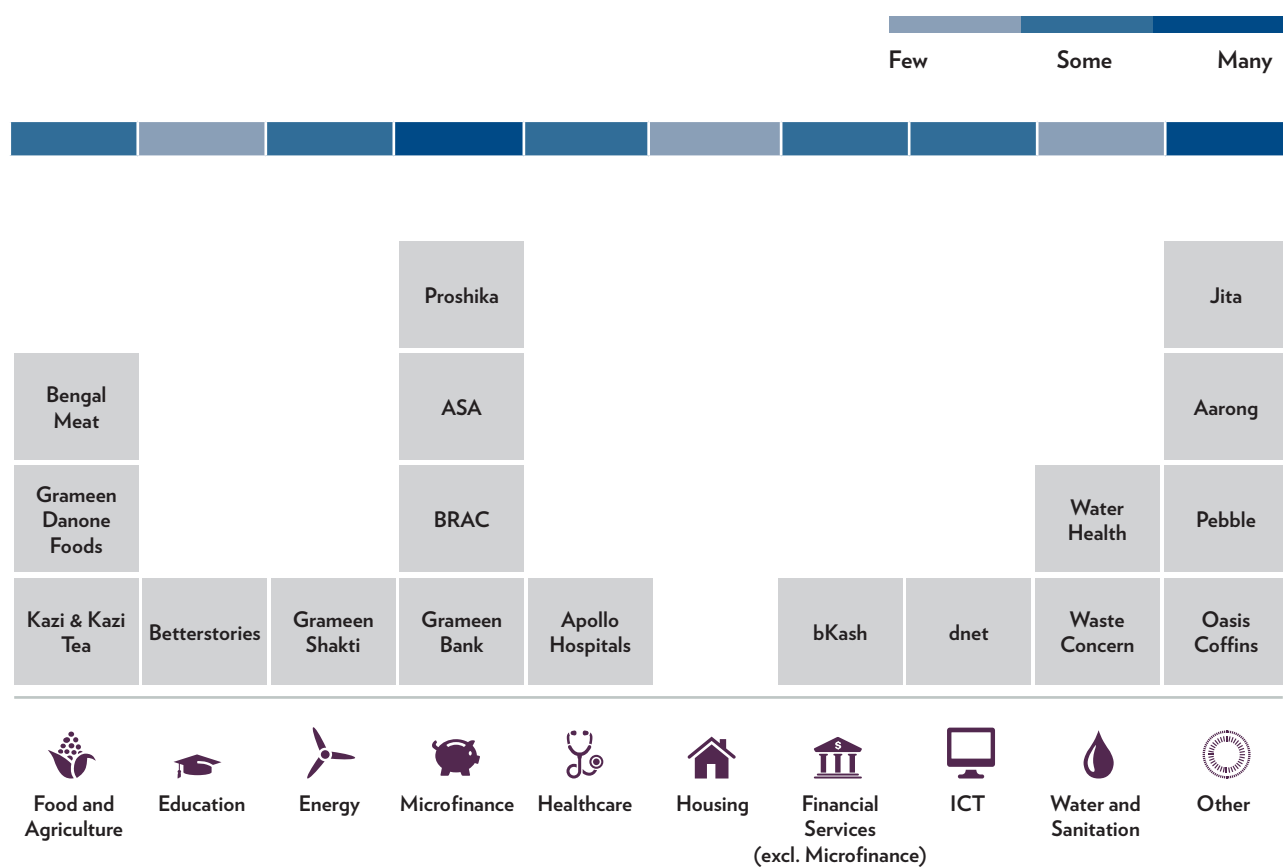
We see impact capital in Bangladesh deployed into a wide range of enterprises, including impact enterprises,³² SMEs, and other companies operating in sectors that make valuable contributions to the economy and generate jobs. Only about USD 6.5 million is currently invested in impact enterprises. The remaining capital has flowed into SMEs and organizations in sectors with a high potential for job creation.

³² *Impact enterprises for the purposes of this report are defined as those that have articulated a core objective to generate a positive social or environmental impact (i.e., as a part of their operating model rather than an ancillary activity as with CSR programs); and seek to increase their financial viability and sustainability.*

Overview of social enterprise ecosystem in Bangladesh

The impact enterprise landscape is vibrant but still developing. The concept of “impact enterprise” is a relatively new one in Bangladesh; however, the landscape is built on a foundation laid by Professor Muhammad Yunus, who introduced the idea of “social business”—a venture that serves a social need by selling a product or service.³³

FIGURE 16: RELATIVE NUMBER OF IMPACT ENTERPRISES BY SECTOR, WITH EXAMPLES



Sources: Yunus, Moingeon, Ortega (2010); Stakeholder interviews; Organization websites; Dalberg analysis

³³ In Bangladesh, Muhammed Yunus first coined the term “social business” to refer to businesses that are designed to address a social problem. “Social businesses” are explicitly non-loss and non-dividend in structure; i.e., profits realized by the company must be reinvested. While this is a term that strongly resonates with Bangladeshi entrepreneurs, investors, and regulators, we have retained the above definition of “impact enterprises” throughout this report in order to maintain consistency across the region but do note the importance of this business approach in creating space for impact enterprises.

The Grameen family and the Bangladesh Rural Advancement Committee (BRAC) pioneered the social business model and have each spun out several entities with a dual social and financial mandate. Both the Grameen Group and BRAC have in-house incubators/accelerators that focus on growing these impact enterprises by providing technical assistance and financing. The sector focus has largely been on renewable energy, healthcare, and manufacturing/retail. In addition, Grameen and BRAC enterprises often provide seed capital for new impact-oriented enterprises, creating an informal impact investing sector that on its own has created a network of 30–40 companies defined as social businesses under the Yunus philosophy. Not all of these may be attractive candidates for impact investors, given that some of them retain their non-dividend philosophy, but some of them have spun out as independent entities. A few examples are provided in Figure 16.

The impact enterprise space is also driven by foreign social entrepreneurs that see an opportunity and have an understanding of social business models.

Foreigners have launched a number of impact enterprises that align closely with various social business models known globally, such as reinvesting profits or focusing on fair trade. For the most part, foreigner-owned impact enterprises are producing their products locally using ethically-sourced, environment-friendly inputs and exporting goods to more developed markets. These entrepreneurs typically launch the enterprise with their own seed funding, but a few have taken investments at venture or growth stages.

Many local entrepreneurs are launching businesses that address a social need, target BoP customers, or incorporate local communities into business operations as suppliers, distributors, or employees, but these entrepreneurs do not explicitly define themselves as impact enterprises. While the impact enterprise model is used in practice, most local entrepreneurs do not self-identify as such. These enterprises, recognizing an opportunity created by gaps in the provision of basic services, are addressing a need through for-profit business models rather than operating with an explicit impact intention, as we see among the Grameen and BRAC entities and foreign entrepreneurs that have launched social businesses in Bangladesh.

Microfinance is the sector with the largest number of impact enterprises, with more than 600 registered MFIs and four very large MFIs. This is unsurprising, given that Bangladesh is often seen as the birthplace of the microfinance model now used around the world, as noted earlier. Among impact enterprises, MFIs are the most active. There are four large MFIs currently active in the country, including the first movers Grameen Bank and BRAC.

Outside of microfinance, renewable energy and ICT (including mobile financial services) are emerging sectors for impact enterprises. Renewable energy enterprises have emerged in response to the limited power infrastructure in Bangladesh. Increasingly, impact enterprises are addressing access to energy issues with mini-grids and solar lighting for homes. With nearly 70% of the population using mobile phones, ICT and mobile financial services are also growing in appeal. In fact, recently, two large players servicing the BoP with ICT services have emerged, and both have received investments greater than USD 10 million.

While growing as impact enterprise sectors, education and healthcare have service gaps that have traditionally been addressed by a large NGO sector offering free services. Given the historical precedent set by an active NGO sector, both consumers and entrepreneurs tend to expect education and healthcare services to be provided free-of-charge.

One gap identified by investors as an impact sector that is largely neglected is housing. There is a sizeable need for low-income housing options, and as NGOs are not addressing all of the need, there is a strong potential for enterprise-based solutions and thus, an opportunity for investors to support such enterprises.

There are four common impact models, or theories of change, that we see among impact enterprises, and these models differ across sectors. First, many impact enterprises aim to create jobs and generate economic growth. These enterprises tend to be in high-growth sectors such as manufacturing. Second, some impact enterprises manufacture products using ethically-sourced, environment-friendly inputs. Often, these products are exported or sold through socially-oriented retail stores. Third, some impact enterprises incorporate low-income or marginalized populations into their supply chains. These are usually agriculture or handicraft production companies. Finally, impact enterprises may provide some much-needed services (such as healthcare services) to the BoP, often through MFI lending. Some enterprises have adopted multiple theories of change. For example, one manufacturer is developing a rural supply chain to source environment-friendly inputs and is setting up production sites in low-income communities.

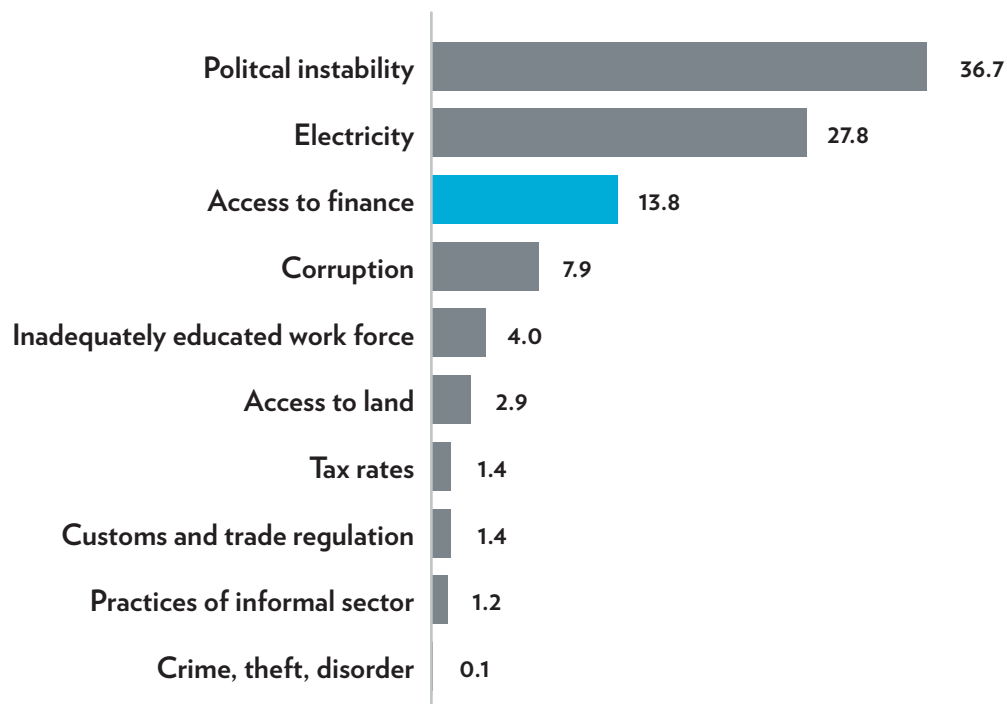
Given the high rate of unemployment and low GDP per capita, both investors and impact enterprises acknowledge job growth as the primary impact focus at present. Irrespective of the sector or business model, most business managers describe their enterprise's impact as job creation, particularly among the BoP or marginalized populations. As described earlier, most impact investors also articulate impact in similar terms.

Access to finance

As in other countries, most impact enterprises were seeded out of an entrepreneur's own savings or from friends/families due to a lack of seed capital available or a reluctance to take on debt/equity. Most early-stage impact enterprises have not accessed formal channels for capital, preferring instead to provide initial financing from their own pockets or from personal networks. The reasons vary, particularly across instruments. For debt, collateral requirements and interest rates are too high to warrant taking a bank loan, particularly for seed capital. With respect to equity, entrepreneurs have several concerns: they are not familiar with the instrument, are reluctant to cede control to an investor, are concerned that the investor's values may not align with the core values of the enterprise (or that the investor will prioritize financial returns over social impact), or feel that they may have difficulty in identifying the appropriate impact investors.

A survey of 1,442 enterprises in Bangladesh³⁴ reveals that access to finance is the third largest constraint for companies (Figure 17). Like investors, enterprises recognize political instability and limited infrastructure as the most significant challenges, but access to finance is also identified as an important issue.

FIGURE 17: CHALLENGES FACING ENTERPRISES IN BANGLADESH (% OF RESPONDENTS)



Source: World Bank Enterprise Survey of 1,442 enterprises in Bangladesh, 2013

³⁴ World Bank Survey of 1,442 enterprises in Bangladesh, 2013. <http://www.enterprisesurveys.org/data/exploreeconomies/2013/bangladesh>

Closely looking at the challenges related to access to finance reveals that growth and venture stage companies face the greatest constraints. As seen in Figure 18, enterprises at these stages have difficulty in both identifying appropriate sources of capital and accessing capital. Formal sources of capital are difficult to secure or are not available for these companies.

FIGURE 18: ACCESS TO FINANCE CHALLENGES ACROSS GROWTH STAGES



Severity of access to finance challenge, by stage of growth



Key challenges faced and severity of impact

Identifying sources of capital

Most impact investors prefer ticket size that is too large for small, young companies

Limited formal sources of capital for start ups; most seed funding from friends, family

Limited number of capital sources outside banks

Difficulty identifying potential equity investors, especially investors that match with values and expectations of entrepreneur

Appropriateness of capital

Entrepreneurs uncertain if legal resource can be taken or will be successful if issues arise with equity investor

Lack of clarity on the regulations for IPO

Terms of loans from banks not appropriate—requires operating history, asset collateral. Interest rates are high

Accessing capital

Difficult to secure reliable third party valuation; methods are old, enterprises themselves don't understand/have capability

Companies have not kept accurate financial records, and investors require 1+ years operating records

Complicated process of applying for capital and negotiating terms of investment, due to lack of investment-related experience

Equity investors locked in for 3 years following IPO listing

Sources: Stakeholder interviews; Dalberg analysis



Identifying sources of capital is the most difficult for early-stage companies. Even though most deals are under USD 1 million, the ticket size is still often too large for young companies. Outside of banks, there are few sources of capital available.

Furthermore, the capital available is often not appropriate for enterprises, particularly in the early stages. Legal and regulatory constraints limit the types of capital available to business managers. Additionally, perceptions of equity and a lack of knowledge about non-debt instruments limit the interest among business managers. The terms for investments are often not appropriate, as debt requires high collateral and investors require an operating history and financial records that many companies do not have. Debt in early stages can also be crippling, due to interest repayment.

Accessing capital is the most challenging area for enterprises across growth stages. Regulations require that equity investors are locked in for three years following an IPO. Also, companies do not keep accurate financial records or are not willing to share records, which investors require during the due diligence process. Lastly, companies often view investments as “rainy-day” funds rather than an injection for growth.

Regulatory challenges are barriers across identifying and accessing capital. Regulations are restrictive, due to both a lack of clarity and, when there is clarity, the perception that the existing regulations and processes are too constraining to facilitate investment.

ENABLING IMPACT INVESTING: THE ECOSYSTEM

Bangladesh has made strong efforts to improve the investment climate through regulatory changes, leading to the country’s gain in the overall ease of doing business, although its rank still remains quite low overall. Bangladesh climbed two spots in 2014 to 130 out of 189 countries in the World Bank’s Ease of Doing Business Ranking, following a downward trend in the rankings in previous years. Strong reforms on paper over the last year to improve the ease and process of starting a business contributed to the abovementioned rise in rank, but the country still scores relatively low overall. Interestingly, Bangladesh scores very high on investor protection, ranking 22 in 2014,³⁵ but it is important to note that this largely reflects the experience of foreign direct investors who have benefited from the country’s steady economic growth and regulation reforms that have promised to open the market for foreign investors, and is less reflective of the capital-only investors (e.g., private equity investors or venture capitalists), who still feel relatively unprotected due to the lack of clarity in the regulations with respect to equity investments and the potential recourse for a contract default.

³⁵ World Bank “Ease of Doing Business” Rankings.

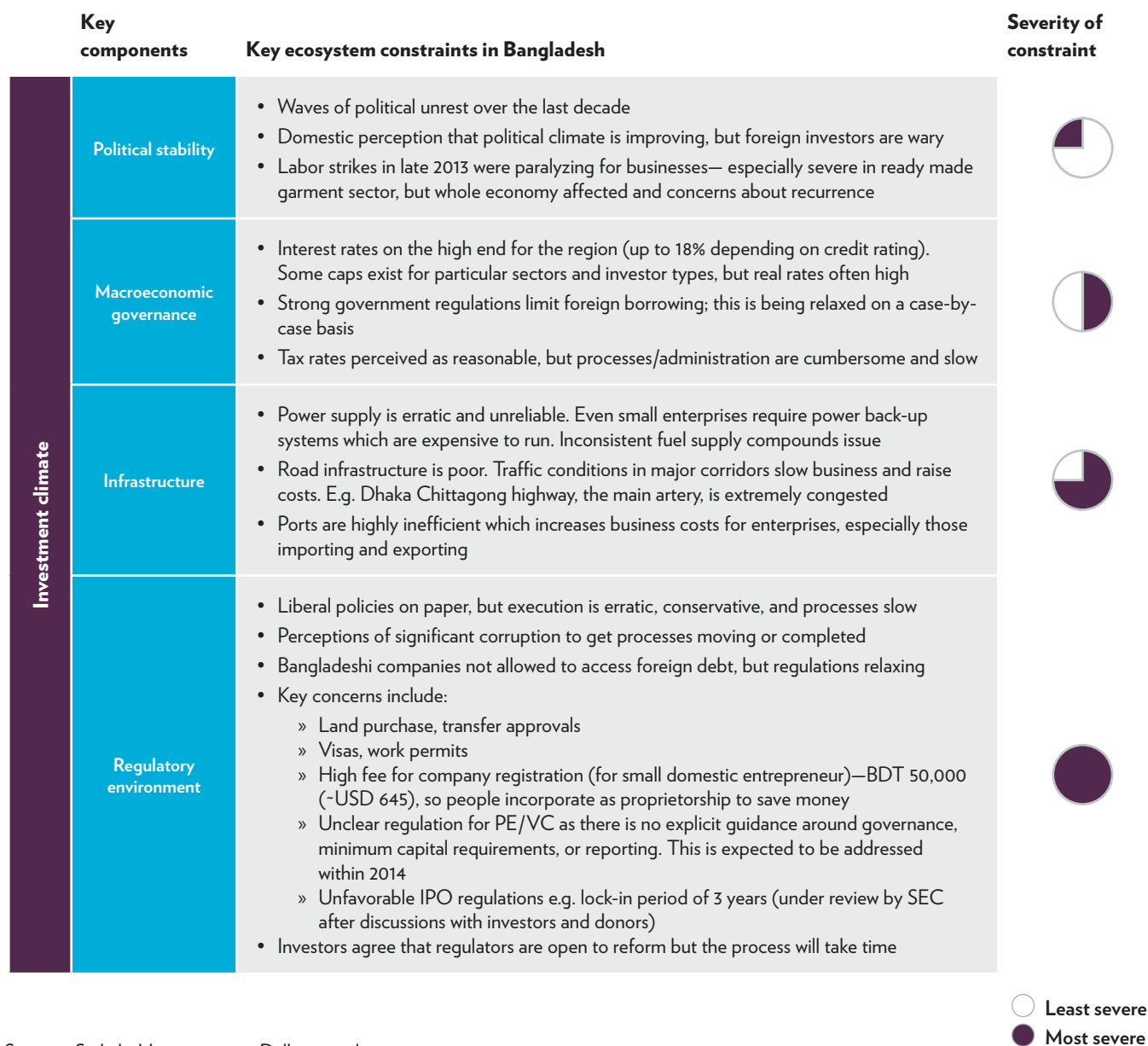
Investors and business managers are enthusiastic about the future trajectory of the country, given its GDP growth, but infrastructure gaps in power and roads, as well as labor issues, remain troubling. While most players in the impact investing market recognize that the investment climate in Bangladesh is improving, there is still skepticism about key gaps. Limited power and poor road infrastructure have prevented the country from realizing its full economic potential (Figure 19). Poor labor laws also remain a barrier to growth, particularly in the manufacturing sector (textile production), which has suffered a few very public tragedies that have spurred debate around labor standards. For instance, the labor strikes in 2013 were paralyzing for businesses in Dhaka, the nation's capital.

Despite regulatory changes that have resulted in a recent increase in the ease of doing business, regulatory constraints remain the largest ecosystem challenge.

While policies are considered liberal on paper, execution is erratic, conservative, and slow. Often, business managers and investors have little certainty about how regulations will play out in practice, despite clear policies in many aspects. For example, investors express that the process for filing for an IPO is uncertain, as the expected timeline varies substantially, regulatory bodies may not follow the process as it is defined, and consequently, the outcome of the IPO is not predictable. While the dominant perception among industry players is that regulatory bodies recognize these constraints and are open to addressing barriers, the consensus is that this process will take time (probably a year or more). Some specific regulations include the following:

- There is a three-year lock-in period for equity investors following a public listing.
- Foreign investors are restricted from investing in companies that are not appropriately registered for receiving FDI.
- Board of Investment must approve deals, rather than just receiving a notification.
- There are some regulatory barriers to repatriating dividends.
- If domiciled in Bangladesh, a fund must be registered with the Government of Bangladesh in order to make investments.
- Foreign investors cannot provide debt to Bangladeshi companies.

FIGURE 19: SEVERITY OF INVESTMENT CLIMATE CONSTRAINTS IN BANGLADESH



Sources: Stakeholder interviews; Dalberg analysis

There are three bodies responsible for the regulation and investment climate in Bangladesh; perceptions of their efficacy and degree of private-sector friendliness vary. Among these bodies, the Bangladesh Securities and Exchange Commission (SEC) is perceived by investors as the most supportive of the pro-investment policies (Figure 20).

FIGURE 20: ROLES, MANDATE, AND PERCEPTIONS OF THE THREE KEY REGULATORS IN BANGLADESH



	Role / mandate	Investor perceptions / challenges
Board of Investment Bangladesh	<ul style="list-style-type: none"> Established in 1989 by the Investment Board Act Mission to encourage private sector investment, to identify constraints to investment, and provide necessary facilities and assistance Services include “investment promotion and facilitation covering support, suggestion and aftercare support to the investors.” 	<ul style="list-style-type: none"> Perception that low effectiveness among bureaucrats reduces utility in practice
Bangladesh Bank	<ul style="list-style-type: none"> Chief monetary and financial system regulator established under Bangladesh Bank Order 1972 Key functions include formulation and implementation of monetary/ credit policies; supervision and regulation of banks and NBFIs; issuance of currency; maintaining deposit insurance scheme; money laundering prevention; acting as banker to the government 	<ul style="list-style-type: none"> Aware of gaps in policy and overly restrictive regulations Perception that the Bank is willing to address gaps and loosen policy, but that process will take some time (one year at least)
Securities and Exchange Commission	<ul style="list-style-type: none"> Capital market regulator; mandated under Securities and Exchange Commission Act 1993 Key functions include: registration/regulation of capital market investors and intermediaries; prevention of fraudulent/unfair trade practices; promoting investor and intermediary training; undertaking investigations/inquiries as needed; conducting research and publishing information 	<ul style="list-style-type: none"> Perception that SEC supports private sector development and is in favour of regulatory changes to improve the investment climate

Sources: Stakeholder interviews; Dalberg analysis

There is a growing support system for investors and business managers, but the budding ecosystem has not been sufficient to fully address needs (Figure 21).

While gaps exist for investors, the largest constraints are for enterprises looking for service providers to assist in building key business skills.

FIGURE 21: CONSTRAINTS TO INVESTOR AND ENTERPRISE SUPPORT IN BANGLADESH

Key components	Key ecosystem constraints in Bangladesh	Severity of constraint
Investor and Enterprise support	<p>Investor support</p> <ul style="list-style-type: none"> • The regulatory process to set up and register a fund is complicated and difficult to navigate with little support available • Few organizations exist that support international investors with their pipeline development—e.g. deal-sourcing or matchmaking is not a commonly available service (this is less of a constraint for domestic investors as their networks tend to be more effective for pipeline development) • Similarly, the dearth of providers of valuation services based on modern methods (e.g. projected cash flows rather than book value or net present value) means both the initial structuring and exiting of equity investments is difficult • On the fund management side, most are first time fund managers, though many have worked in banking/financial services (and several with Grameen/BRAC networks) and some have international experience, but in general, fund management experience is low, and exposure to international learnings and best practices are limited so there is some need for training and networking to build this capacity for fund managers in the impact investing space • Limited complexity in impact measurement, as many funds are new and many managers are new to impact investing 	
	<p>Enterprise support</p> <ul style="list-style-type: none"> • In addition to access to finance challenges, entrepreneurs face a range of other constraints to growth including their own business mindset, skills and knowledge, as well as access to information and networks. • Few organizations currently exist to support/address these needs in a comprehensive, easy-to-access way, and those that exist are relatively new and have minimal reach • Key areas of need include: <ul style="list-style-type: none"> » Aggregation/networking/knowledge sharing amongst entrepreneurs » Training in key business management functions—both strategic and operational » Linkage to investors or platforms for accessing investor information 	

Sources: Stakeholder interviews; Bangladesh Enterprise Institute studies; Dalberg analysis

○ Least severe
● Most severe

Investors often find themselves providing technical assistance (TA) to enterprises in order to fill ecosystem gaps. Many enterprises are not receiving the development support that they require. As a result, at least six investors are also providing TA in the form of direct management support to business managers in order to help the enterprise progress to an investable level (in the case of pre-investment support) and to increase profitability (for post-investment support). Often, the TA focuses on basic skills around structuring a company for an investment and setting up governance structures. Some investors are also providing financial support to SMEs for securing TA.

In addition, formal ecosystem players have emerged, but most are new to the space. A small number of incubators and accelerators have launched within the last year, but most are still piloting their services, which primarily include improving

investment readiness of enterprises (maintaining financial records, developing a business plan, pitching to investors, etc.) and strategy design. Ecosystem players are also hosting networking events and workshop trainings, but these are relatively new. Access to these services is limited, not just because these service providers are few in number, but also because these services are restricted to Dhaka and awareness of these programs is limited.

Credit rating agencies are the most active in this field, but most impact investors are not utilizing their services, even for conducting valuations. Regulators have licensed a large number of credit rating agencies, which some speculate is due to political considerations as Bangladesh has more credit rating agencies than any of its neighbors, including India or China. However, only banks are using their services for assessing the credit worthiness of borrowers. Other investors do not use credit rating services, even for conducting valuations, despite the lack of formal valuation knowledge among many investors (particularly local investors) and business managers.

FIGURE 22: ACTIVE ECOSYSTEM PLAYERS IN BANGLADESH

Incubators/Accelerators



Advisory Services



Credit Rating Services



TA Providers



Sources: Stakeholder interviews; Bangladesh Enterprise Institute studies; Dalberg analysis

AREAS FOR FURTHER RESEARCH

In order to further understand the opportunities in the impact investing market in Bangladesh, we propose several areas for further research.

First, given that impact investing in Bangladesh is beyond the idea phase, as in some other South Asian markets, investors are seeking more sophisticated ways of measuring their impact but lack good examples or tools to do so. As part of the maturing process of the impact investing landscape, given that investors have a history in the market, the desire to be more rigorous about impact measurement and to tailor impact metrics to different sectors and types of enterprises requires further study on tools for the Bangladeshi context. Investors and enterprises alike are looking to move beyond output measurement to outcome and impact measurement, and will benefit from a resource that examines these within the local setting.

Second, there are opportunities for exploring the potential role of the Bangladeshi diaspora's contribution to the growth of the investment landscape in several ways. Either through a mobilization of networks abroad, or through direct investments in their home country, a significant amount of potential capital can be unleashed provided there are appropriate awareness and channels to do so. Furthermore, Bangladeshis who have acquired experience in the financial services industry abroad are also now returning and managing funds. Research on capitalizing on the movement of the diaspora, and providing a clear overview of the opportunities to optimize this engagement, can contribute to the growing impact investment market in Bangladesh.

Lastly, as the market in Bangladesh evolves, an increasing number of investors are interested in public listings as an option for exiting their investment. In reality, however, only the first impact investment is going through an IPO at this moment, and the process is largely undefined. Additional research and information to support strategic exit options, including the definition and analysis of the conditions under which certain exit options are better than others and a preparation during earlier stages of the investment, will be considerably beneficial for both investors and investees.

NEPAL



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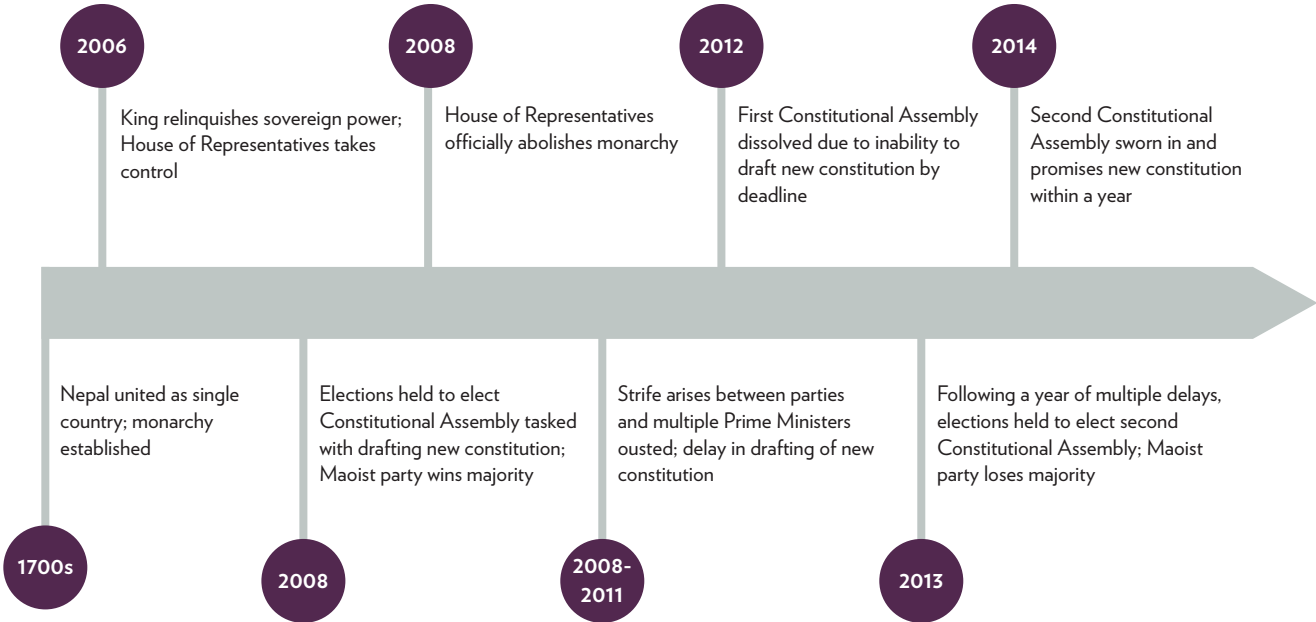
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COUNTRY CONTEXT

Overview

Nepal's small population, low GDP per capita, and political instability are deterrents to investments in the country, resulting in the country having the second smallest impact investing market by capital deployed among the countries under study (slightly larger than Myanmar). Nepal, with a population of 27.5 million and a GDP per capita of about USD 690 (at the current USD exchange rate),³⁶ is passing through a momentous and a prolonged transition following a 10-year-long violent conflict that ended in 2006. Since monarchy was abolished in 2008, there have been numerous attempts to draft a new constitution (Figure 1). Following a year of multiple delays, elections were held in 2013 to elect the second Constitutional Assembly. The Maoist party lost its majority, and the new government is now committed to delivering a new constitution by 2015.

FIGURE 1: TIMELINE OF KEY EVENTS IN NEPAL'S POLITICAL HISTORY



Source: BBC Nepal profile < <http://www.bbc.com/news/world-south-asia-12511455> >

³⁶ World Development Indicators, The World Bank, 2013.

The implications of this for investors are numerous:

- Nepal's political instability has brought about low investor confidence. Investors will only feel confident in a politically stable environment and a government that will hold for a reasonable length of time (e.g., five years). Further, Nepal's policy and regulatory environment is uncertain, highlighted by the lack of a constitution. However, there is a general belief among domestic investors that the recently sworn in Second Constitutional Assembly will have a new constitution within a year, as promised, leading to tempered optimism within the investment community.
- On the positive side, diminished Maoist power has created space for more private sector activity and a more supportive agenda for policy reform, again creating optimism among investors.
- This has also meant decreased labor volatility. In the early 2000s, labor strikes were paralyzing the country, but have since reduced in frequency and severity.

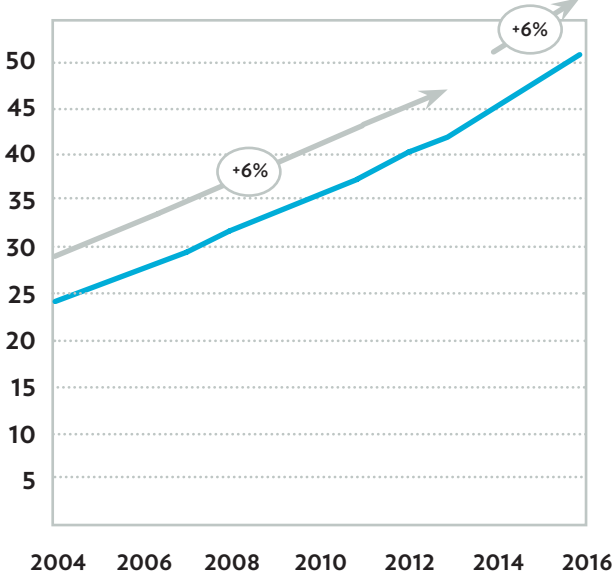
GDP growth and drivers of FDI

Nepal has seen steady GDP growth at about 6% per annum since 2004 and is expected to continue this trend through 2016, but its GDP remains the lowest among the countries under study. Nepal's total GDP in 2013 was only 42 billion (PPP, international dollars),³⁷ as seen in Figure 2. At 6% per annum from 2014 to 2016, the forecast growth is also one of the lowest in the region.

FIGURE 2: GDP OF NEPAL (PPP, INTERNATIONAL DOLLAR, BILLIONS): CHANGE OVER TIME AND 2013 COMPARISON WITH THE REST OF THE REGION

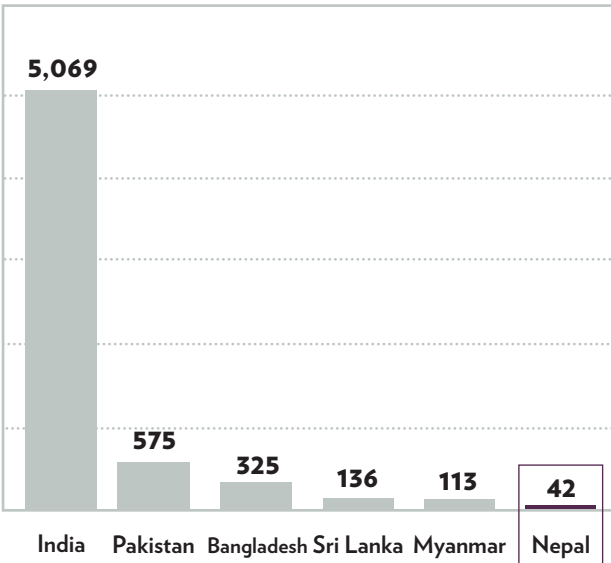
GDP OF NEPAL

(PPP, CURRENT INTERNATIONAL DOLLAR, BILLIONS, 2013)



GDP, BY COUNTRY

(PPP, CURRENT INTERNATIONAL DOLLAR, BILLIONS, 2013)



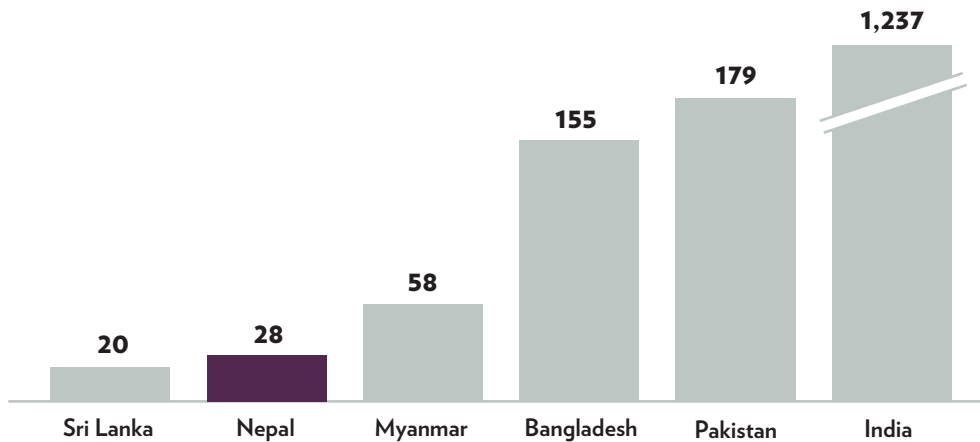
Source: International Monetary Fund (IMF) World Economic Outlook Data 2014. Notes: 1990-2013 actual, 2013 estimated, 2014-2016 forecasted figures as of June 30, 2014.

With the second smallest population in the region and the smallest GDP per capita among the countries under study, Nepal's consumer expenditure and market potential are not seen as very attractive for investors. At a population of 27.5 million³⁸ (Figure 3), Nepal is considered a small market by investors. The population size, coupled with a low GDP per capita, are seen as deterrents for investors, who express concern that low relative consumer expenditure and market potential do not warrant the high risk of investing in the country.

³⁷ IMF World Economic Outlook Database.

³⁸ World Development Indicators, The World Bank.

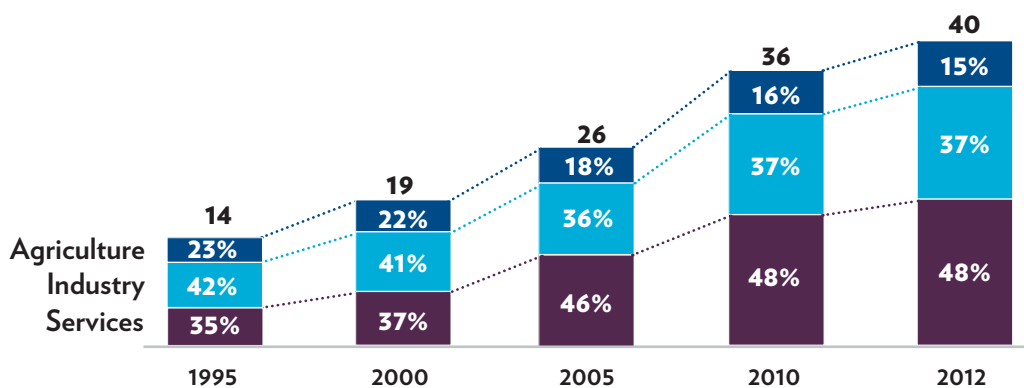
FIGURE 3: POPULATION OF NEPAL AND REGIONAL COMPARISON (MILLIONS)



Source: World Development Indicators, The World Bank

Growth trends and investor interest are observed in some economic sub-sectors, particularly tourism and hospitality, and hydropower. Within the services sector, tourism and hospitality is a fast-growing sub-sector, creating employment for about 20% of the economically active population and accounting for 3% of the GDP.³⁹ While holding the GDP share steady, the industry sector⁴⁰ is growing in absolute terms, contributing to 37% of the country’s GDP⁴¹ due to the strong growth of hydropower and textiles, which continue to be attractive to investors. In fact, Nepal has one of the largest untapped hydropower resources in the world—an estimated 83,000 megawatts of hydropower potential.⁴²

FIGURE 4: SECTOR SHARE OF GDP OVER TIME (PPP, INTERNATIONAL DOLLAR, BILLIONS)



Sources: World Development Indicators, The World Bank; IMF World Economic Outlook

39 Bishnu Prasad Gautam, *Tourism and economic growth in Nepal, 2011*.

40 Industry defined by ISIC Rev 3 as mining, manufacturing, construction, electricity, water, and gas.

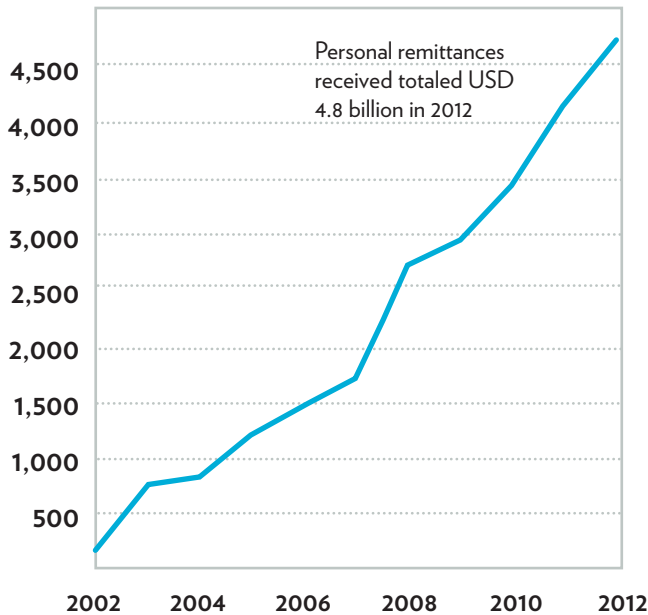
41 World Development Indicators, The World Bank.

42 World Bank Nepal Overview.

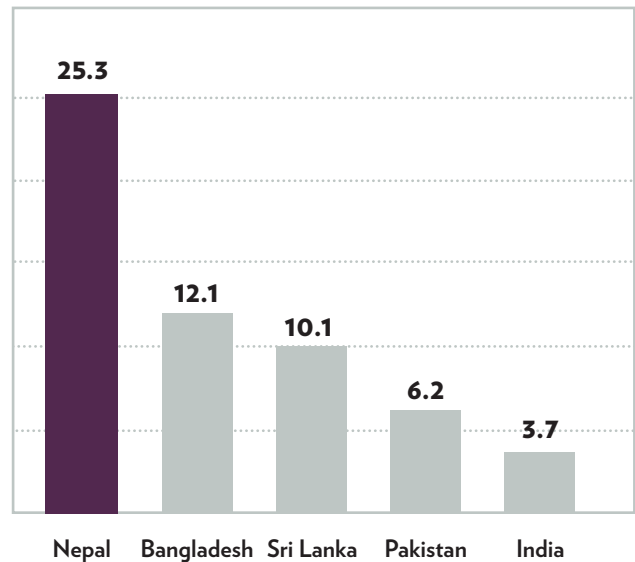
A key driver of growth, primarily through increased consumption, is remittance income from Nepal's large migrant working population. Personal remittances totaled USD 4.8 billion in 2012.⁴³ Remittances accounted for about 25% of the GDP, significantly higher than in any of the other countries under study. Remittances are driving increases in consumption as well as expenditure on private services such as education and healthcare. Remittance income also represents an important source of capital for asset purchase (land, houses, etc.), which in turn can serve as collateral for loans to provide seed funding to entrepreneurs.

FIGURE 5: PERSONAL REMITTANCE INFLOWS: NEPAL OVER TIME (CURRENT USD MILLIONS) AND COMPARED WITH THE REST OF THE REGION (AS A PERCENTAGE OF GDP)

PERSONAL REMITTANCES SENT TO NEPAL
(MILLIONS, CURRENT USD)



PERSONAL REMITTANCES SENT BY COUNTRY
(% OF GDP, 2012)



Source: World Development Indicators, The World Bank

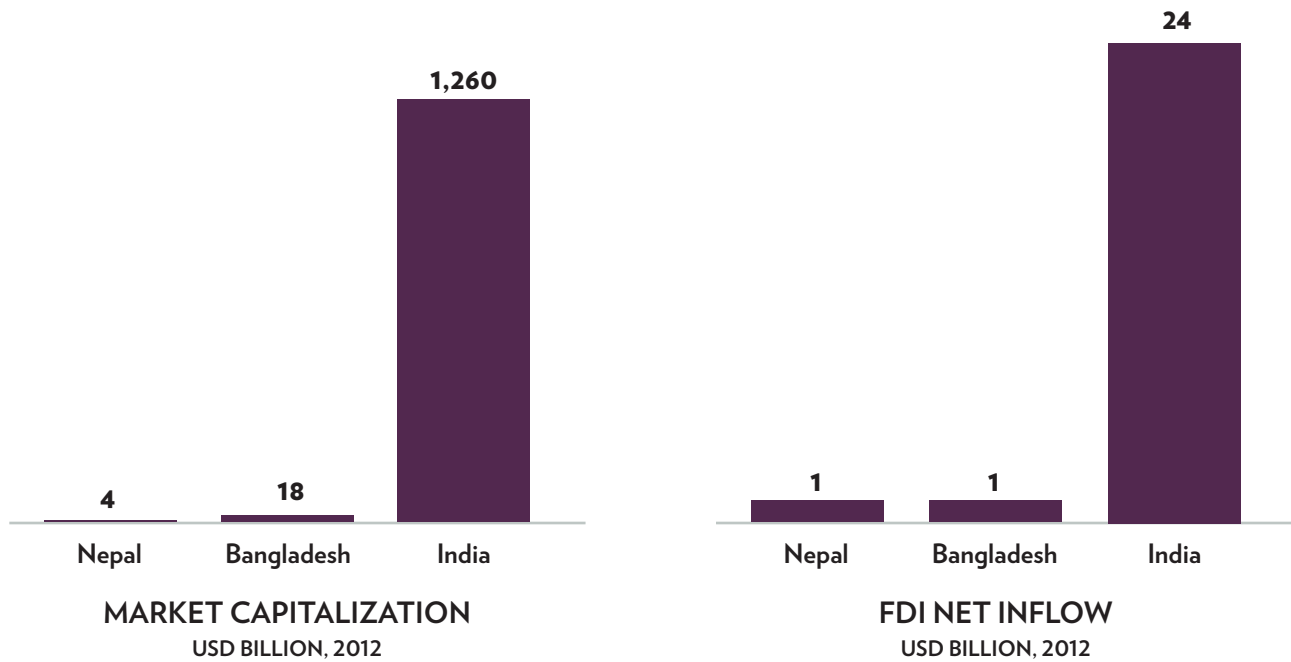
Despite these positive markers and trends, overall investor confidence has been low, reflected in low capital market investments and FDI inflows. In 2012, FDI net inflows reached about USD 1 billion, or about 4.9% of the GDP.⁴⁴ In the same year, market capitalization totaled USD 4.1 billion.⁴⁵ Investors considering opportunities in the region would prefer to invest in larger, more dynamic markets such as India and Bangladesh.

⁴³ World Development Indicators, The World Bank.

⁴⁴ World Development Indicators, The World Bank.

⁴⁵ World Development Indicators, The World Bank.

FIGURE 6: MARKET CAPITALIZATION AND FDI IN NEPAL COMPARED TO ITS REGIONAL NEIGHBORS



Source: World Development Indicators, The World Bank; IMF Balance of Payments database

Domestic investors are also not heavily engaged, in large part due to the population’s low levels of access to financial services as well as a poor understanding of and a relative lack of trust in these services. Given the extremely low levels of access to financial services in Nepal in the mid-2000s, the government and the central bank undertook extensive efforts to increase access to banking services across the country. The banked population grew considerably to approximately 40% in 2013 from 26% in 2006; however, while savings/deposits have increased, lending and investment in general remain low, reflecting low levels of familiarity with, and trust in, other asset classes. For example, the domestic capital market remains small and fairly illiquid—many listed companies are banks or financial institutions, which, by government mandate, must offer 30% of their equity to the public.⁴⁶

Key constraints and opportunities in Nepal

Nepal’s weak basic infrastructure is a major challenge, making it costly to run businesses and difficult to access markets or build supply chains. Despite a relatively high electrification rate (76% of Nepalis have access to electricity⁴⁷), supply

⁴⁶ Nepal Stock Exchange.

⁴⁷ International Energy Agency, Key world energy statistics, 2013.

is unreliable and hours of access are few; therefore, the population is heavily under-electrified (as reflected by the low per capita energy consumption), and back-up power supplies for businesses and industry are extremely expensive. Road networks are few, leaving much of the country inaccessible and economic activity very heavily concentrated in the Kathmandu Valley.

While these business constraints mean lower attractiveness of Nepal for investors seeking purely financial returns, investors with impact objectives have an opportunity to address significant social needs by investing to promote basic services, infrastructure, and economic opportunities. Nepal is among the poorest countries in the world and currently ranks 157 out of 187 countries on the Human Development Index.⁴⁸ Although reduced from 53.1% in 2003, 24.8% of the population still lives below the World Bank USD 1.25 per day poverty line (PPP) as of 2010.⁴⁹ Gaps in basic services—such as healthcare and education—and poor infrastructure contribute to this poverty. For impact investors, these gaps present an opportunity to achieve their social mandate, albeit in a difficult market.

INVESTING IN NEPAL: THE SUPPLY SIDE

Overall, impact investing in Nepal is fairly limited, reflecting a small investment landscape at-large. Approximately USD 17.3 million has been deployed by impact investors in Nepal to date, of which USD 16 million has been deployed by DFIs. Investors see the small population of Nepal, low GDP growth (relative to other countries in the region), limited infrastructure, and political uncertainty as deterrents to investing in the country. As a result, in Nepal, the risk capital market is largely driven by impact investors (unlike in other markets where there is an existing set of commercial private equity (PE)/venture capital (VC) investors). For commercial players, the viability or potential of the market is unproven and unclear. Therefore, while there are few active players, those that are present are explicitly impact driven (however, even these players are still largely testing the market).

The broad impact capital market in Nepal

There are eight impact investors active in Nepal (Ring 1),⁵⁰ although half of these are in an indeterminate state. Of these eight investors, there are five local funds, two development finance institutions (DFIs), and one regional fund, as shown

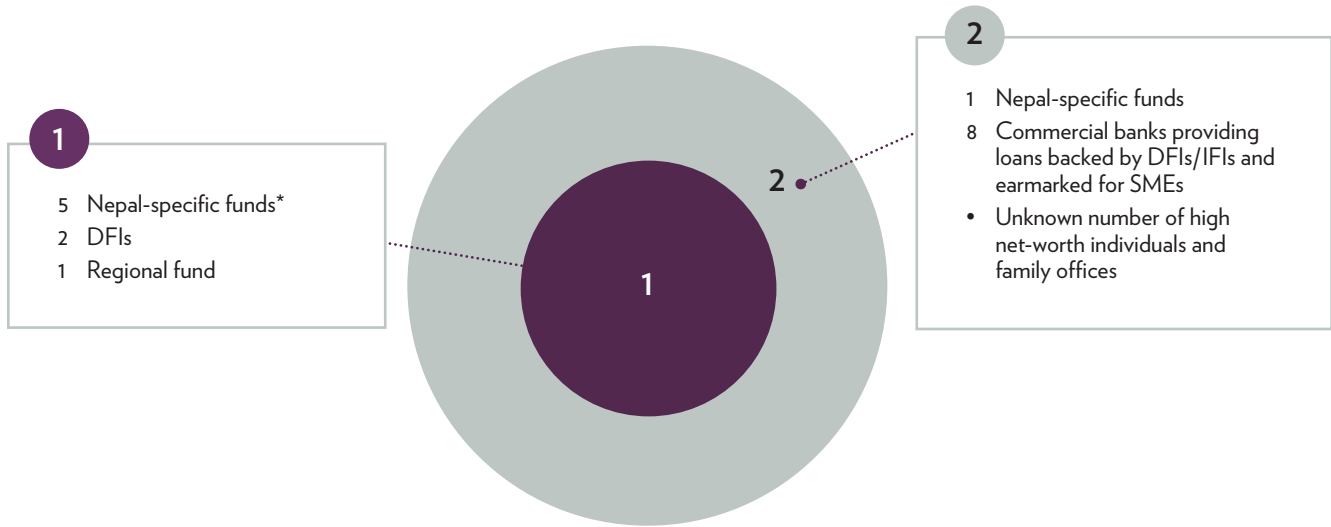
⁴⁸ UNDP, Human development reports, 2013.

⁴⁹ World Development Indicators, The World Bank.

⁵⁰ In this report, we use a simple framework to categorize investors. The inner ring—Ring 1—represents impact investing activity, and the outer ring—Ring 2—represents activity related to impact investing but which may lack either explicit impact intention or a commitment to measurement.

in Figure 7. Four funds that have raised capital have either not yet deployed, or have been put on hold, or have closed due to management issues or the difficult market. These challenges will be discussed further in the section “*Challenges facing impact investors in Nepal.*”

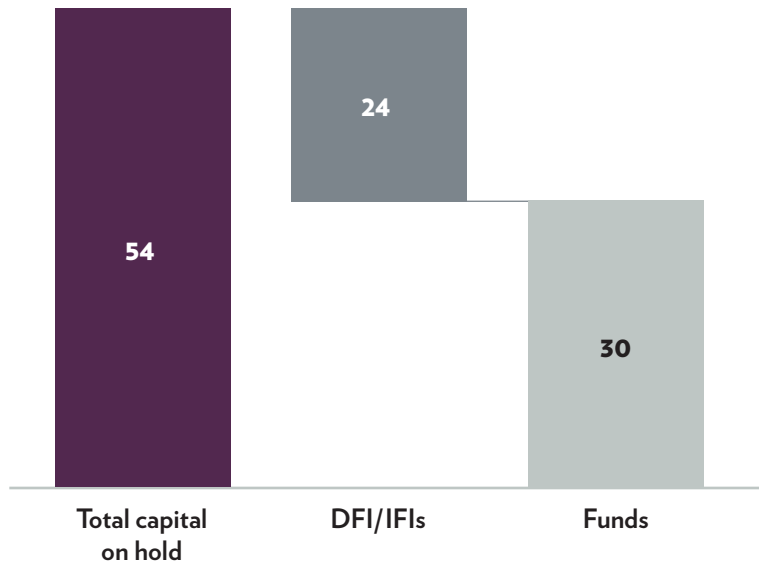
FIGURE 7: NUMBER OF DIRECT IMPACT AND IMPACT-RELATED INVESTORS ACTIVE IN NEPAL



Source: Stakeholder interviews; Investor websites; Dalberg analysis. *Notes: Two of these funds have raised capital but have not yet been deployed; another two funds have been put on hold according to the other players in the market.

An additional USD 54 million is expected to be deployed soon. This capital has been raised but put on hold in part due to internal management constraints, difficulty in closing funds, and other challenges as will be discussed later in this chapter. Of this capital, USD 30 million has been raised by two large funds and is waiting to be deployed, and the remaining USD 24 million has been committed by DFIs as direct investments into enterprises (Figure 8). While this additional capital commitment signals a growing interest in the market, it also reflects the difficulties that investors have had in securing investments.

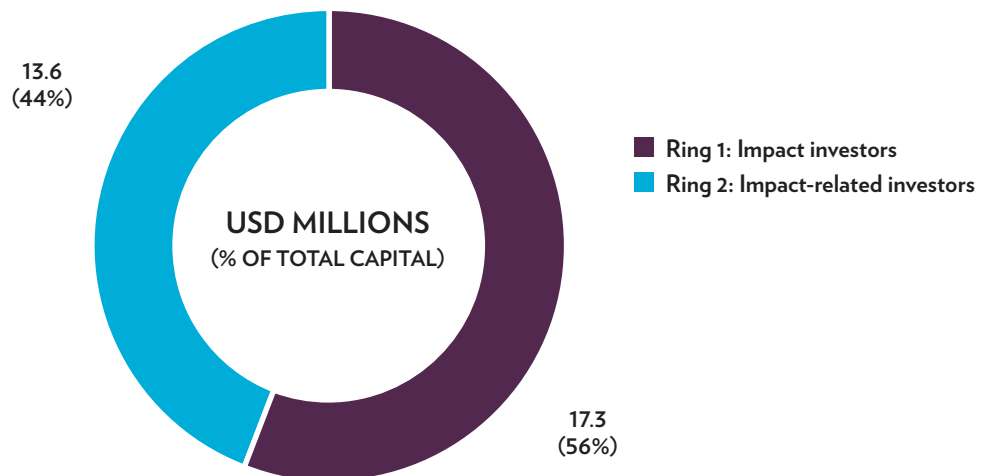
FIGURE 8: TOTAL CAPITAL RAISED OR COMMITTED BY IMPACT INVESTORS IN NEPAL, BUT NOT YET DEPLOYED (USD MILLIONS)



Source: Stakeholder interviews; Investor websites; Dalberg analysis

Outside of impact investors, there are nine periphery impact-related investors active in Nepal with about USD 13.6 million in current investments. These investors include one Nepal-specific fund making small investments ranging from USD 2,000 to USD 8,000. Eight commercial banks are also making SME loans backed by DFI funding. As shown in Figure 9, these impact-related investors have made 44% of the total investments by amount.

FIGURE 9: TOTAL CAPITAL DEPLOYED BY RING



Source: Stakeholder interviews; Investor websites; Dalberg analysis

Active impact and impact-related investors in Nepal

There is a range of different types of investors active in Nepal, but only a limited number of each type. While we see funds, DFIs, diversified financial institutions/banks, and family offices/high net-worth individuals (HNWIs) present as in other markets, most are still testing the market with a minimal number of investments. There have been some recent efforts by local fund managers to raise new funds, but these are largely not yet active or deploying capital.

While at present, foreign fund managers express a low appetite for investments in Nepal, domestic funds are slowly emerging, and although most of these funds are facing difficulties in closing and deploying capital, they are shaping the market. Only one foreign fund has entered the country with a small investment. All other funds are domestic. Two of these domestic funds (both small with less than USD 1 million in capital to deploy) have made a series of small deals as they test the market. Given the dearth of commercial private equity investors and venture capitalists, these funds are playing a vital role as the first movers to demonstrate market viability and as policy advocates with the government. The largest fund to date (with a portfolio of USD 20 million) has recently closed and is expected to begin deploying capital soon. This will signal a significant step for the market as the amount of capital deployed by funds will then rival the direct investments by DFIs (as compared to other markets where DFI investments dwarf investments made by fund managers).

DFIs are the most active players in the market by capital deployed, but these too have only entered the market recently and are still very much testing the waters. In contrast to other countries where DFIs are trying to play a more catalytic role and to move the market, in Nepal, DFIs are still quite wary. As direct investors, DFIs are only making deals less than USD 10 million. Even though DFI activity is less than in Nepal's regional counterparts—in terms of both the number of deals and the size of these deals—DFIs are still a large segment of the impact investing market, accounting for 93% of the total deployed impact investing capital (56% if we include the committed capital yet to be deployed).

Recognizing their potential role as market catalysts, DFIs are using guarantees as an investment instrument in Nepal as well as their direct lending to commercial banks. As in other countries, DFIs are backing SME portfolios for commercial banks to increase lending to these enterprises. The guarantees have been to five banks to promote SME lending in the range of USD 40,000 to USD 8 million each (totaling USD 12.3 million) and three loans to banks in the range of USD 260,000 to USD 800,000 (totaling USD 1.4 million). These investments reflect the DFI interest in testing the market without excessive exposure, as well as their interest in increasing SME access to finance in the country.

DFIs are also acting as limited partners (LPs) for two funds, both of which have yet to launch. Three DFIs have backed two domestic funds—one for USD 20 million and the other for USD 10 million. Neither fund has yet deployed capital, but one is expected to close its first deal soon. Additionally, at least one bilateral donor and one DFI have assessed the possibility of anchoring sizable equity funds for Nepal, but the limited track record of the existing funds and the low level of experience of these funds have been the deterrent factors.

DFIs and donor agencies play an active role in promoting and advocating pro-investment policy changes on behalf of the investment community. DFIs and donors, in collaboration with fund managers, have been working closely with regulators to address gaps and constraints in regulatory frameworks. Regulators perceive DFIs and donor agencies as knowledgeable and credible sources, and have addressed some concerns raised by these parties, including a recent change to blacklisting laws from which foreigners are now exempt (regulations will be discussed further in the section titled “Challenges facing impact investors in Nepal”).

Diversified financial institutions and banks have been fairly inactive as impact investors. SME lending from commercial banks is limited as the 117 domestic banks and 90 non-bank financial institutions (NBFIs) have been reported to shy away from small deals and prefer to finance the less-risky, well-collateralized, and diversified business houses. Further, there has been some effort to promote increased lending to SMEs by financial institutions through government mandates and DFI guarantees, but given the large unbanked population in Nepal, it is still difficult to reach SME owners with formal financial services. Only a small amount of capital—largely debt provided or guaranteed by DFIs but on-lent through the commercial banks—is being channeled through institutional investors.

Domestic family offices and HNWIs are operating largely informally—without formal fund structures or stringent timelines. HNWIs, as well as the families of the leading business houses, are often considered to be the sources of seed capital. This happens informally and through networks that are not easy to access. There is one group of young investors that is starting to engage more formally as angel investors, but this has not been institutionalized. As in other countries, friends and family members also serve as a source of capital, particularly through remittance income. International HNWIs are also slowly engaging in Nepal, particularly through one asset management firm that matches these investors with enterprises. The asset manager works to identify potential investees, determines capital needs (as well as business development support needs), and approaches an existing network of investors outside Nepal to secure the needed capital.

FIGURE 10: TYPES OF IMPACT INVESTORS AND IMPACT-RELATED INVESTORS ACTIVE IN NEPAL

TYPE OF INVESTOR	ESTIMATED NUMBER	DETAILS OF INVESTORS IN NEPAL
Funds and fund managers	7 (6 impact investors)	Small local funds are slowly emerging and have been critical in shaping the market, given the limited number of impact and commercial investors in the country, but many have been put on hold, shut, or delayed due to difficulties in raising capital and management issues.
DFIs	2 (2 additional ones are anchoring funds)	DFIs are making direct investments, anchoring two funds, providing guarantees and loans to banks to promote SME lending, and advocating regulatory changes on behalf of the investment community.
HNWIs/Family offices	Likely many informal ones	Friends and family are a significant source of seed capital, and HNWIs are starting to engage informally.
Diversified financial institutions/banks	8 providing loans with DFI backing	The large unbanked population implies that many SME owners cannot be reached through formal financial institutions; therefore, bank lending is limited, but eight banks are providing SME loans with funding from DFIs.

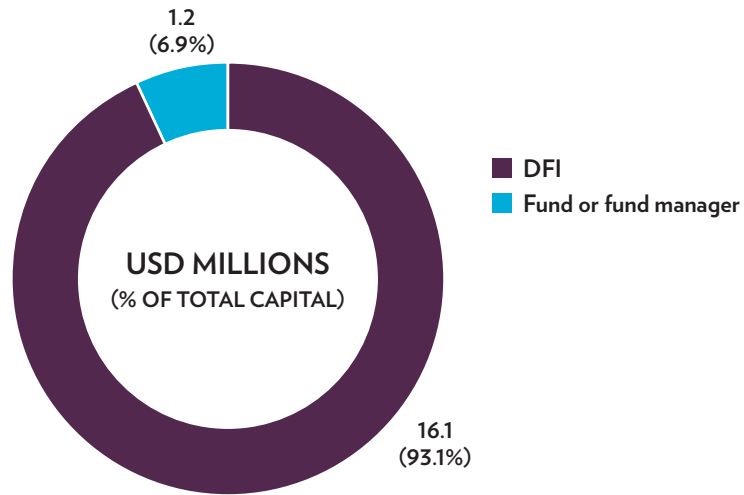
Key trends in impact investing in Nepal

The following section examines the trends among impact investors. The figures quoted in this section refer only to this set of investors, who have collectively deployed about USD 17.3 million to date. The activities of impact-related investors will be discussed in the section “Beyond the impact investing market.” Despite the small amount of capital deployed in Nepal, we see trends emerging around features such as instrument, growth stage, sector, deal size, and return expectations.

INVESTOR MIX

As discussed, two DFIs are responsible for 93% of impact capital currently deployed, or USD 16 million. The remaining USD 1.2 million has been deployed by two small funds.

FIGURE 11: IMPACT CAPITAL DEPLOYED BY INVESTOR TYPE



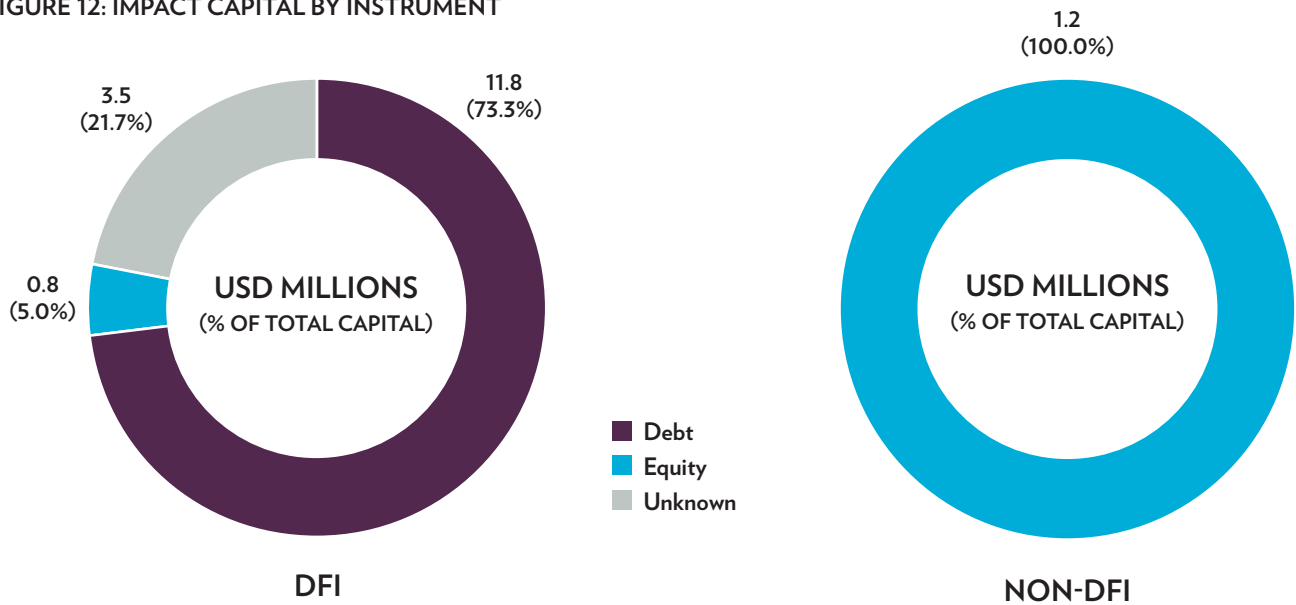
Sources: Stakeholder interviews; Investor websites; Dalberg analysis

INSTRUMENT

Debt is the preferred instrument for most of the overall impact capital in Nepal.

DFIs are responsible for these trends as they are testing market viability through these relatively low-risk instruments. DFI debt investments account for at least 73% of capital deployed by impact investors, whereas equity is about 5% (Figure 12).

FIGURE 12: IMPACT CAPITAL BY INSTRUMENT



Sources: Stakeholder interviews; Investor websites; Dalberg analysis

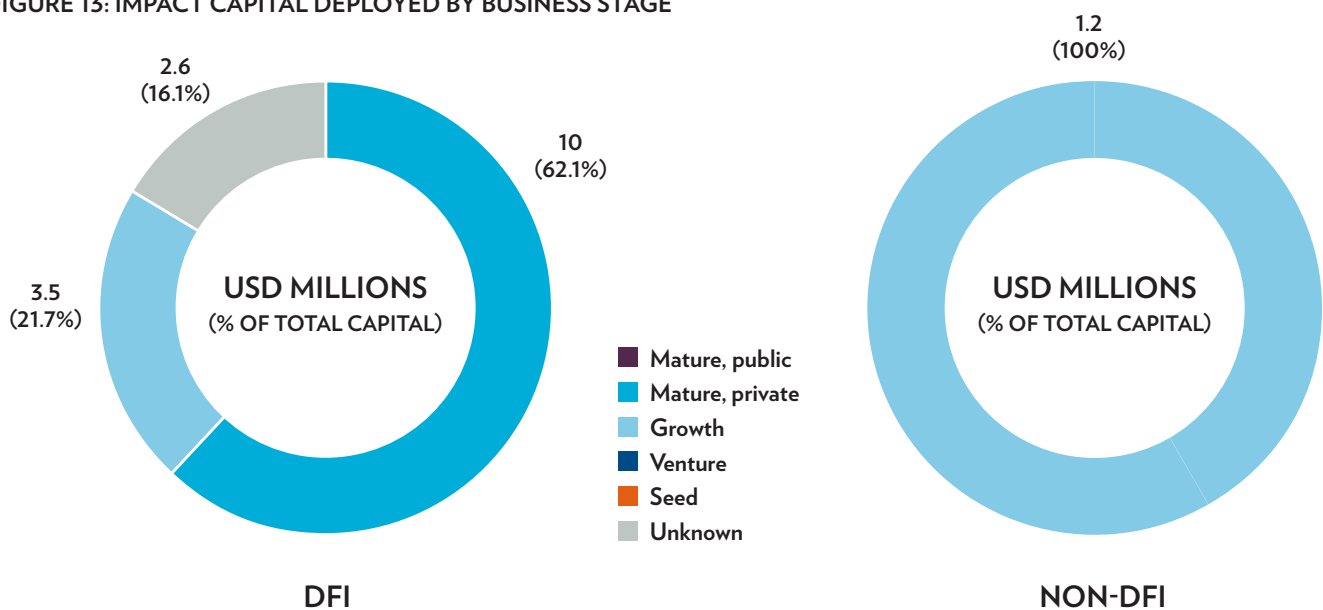
Regulatory uncertainty around equity makes debt preferable. Even among investors that have not yet deployed capital, debt is identified as the most feasible and least risky instrument. As a new instrument, the regulatory rules and processes around equity have not yet been fully defined in Nepal. Equity deals must get the approval of the country’s central bank, but the process for approval is long and not well-defined, leaving investors uncertain about what to expect. In addition, domestic investors can be blacklisted from financial markets or services if they provide equity to a company that fails (foreign investors have recently been exempted from these regulations).

However, equity is being tested in small amounts, particularly by investors that are not legally allowed to provide debt. While regulations around equity are stifling for investors, debt is outright prohibited for certain investors. In particular, in order to provide debt, an investor must be registered as a bank in its country of origin. For small funds, this is unfeasible, so they are testing the market through equity investments.

GROWTH STAGE AND DEAL SIZE

Most of the currently deployed impact capital has been invested in mature companies; this is strongly driven by one large investment by a DFI. As is the case in the other countries considered in this study, DFIs prefer to make investments larger than USD 1 million, but only a small number of companies can absorb capital of this amount in Nepal—and these are primarily mature. As such, given the small amount of capital deployed and only around six deals made, the DFI investments drive an observed preference for mature companies.

FIGURE 13: IMPACT CAPITAL DEPLOYED BY BUSINESS STAGE



Sources: Stakeholder interviews; Investor websites; Dalberg analysis

All known investments from non-DFI investors are in growth stage companies, as the capital requirements for these companies match the small ticket size of funds that are currently active. For these non-DFI investors, ticket size limitations of less than USD 1 million are driving their preference for growth-stage companies. These investments have been less than USD 200,000 in size.

Seed capital represents a funding gap among formal impact investment channels but is addressed by informal networks such as friends and family. No seed capital has been provided by formal impact investors, and it is difficult for entrepreneurs to secure seed funding from commercial banks, due to high collateral requirements and general reluctance on the part of banks to fund early-stage ventures. As a result, entrepreneurs access seed capital through informal channels such as self-financing, friends, and family. Nepal's significant remittance inflows are likely driving much of this informal lending by friends and family.

All four of the known non-DFI deals in Nepal are less than USD 1 million in value; the two known DFI investments are significantly larger. As a result of two larger deals made by DFIs, the larger of which is USD 10 million, the overall average deal size across all known deals is approximately USD 2.4 million. Specific portfolio information was not available for one DFI; hence, the number of deals made is unknown.

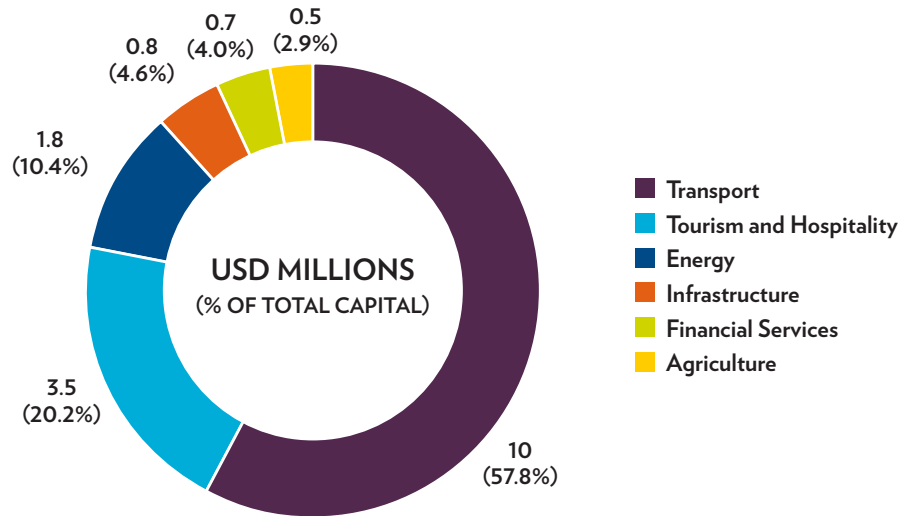
We see small deal sizes as investors are wary of the market, small investors are looking to diversify their portfolios, and only a limited number of companies are capable of absorbing large capital infusions. As discussed previously, a limited number of investment-ready companies can absorb large amounts of capital (more than USD 1 million). DFIs, while able to deploy larger ticket sizes, are still new to the market. Smaller funds are looking to diversify their portfolios to minimize risks and are therefore, deploying smaller ticket sizes to allow for a greater number of deals. These funds have only made deals under USD 1 million.

Deal size trends are likely to shift as two large funds begin to deploy capital. While small ticket sizes have been the norm to date, two large funds are entering the impact investing market with expectations of deploying ticket sizes greater than USD 1 million, and focusing on renewable energy, tourism, education, information and communication technology (ICT), healthcare, and agriculture.

SECTOR

Transport and tourism and hospitality are two sectors that are currently receiving the largest portion of capital, but these preferences simply reflect two DFI investments. Collectively, these sectors have absorbed 78% of capital.

FIGURE 14: IMPACT INVESTMENTS BY SECTOR (BOTH DFI AND NON-DFI INVESTORS)



Sources: Stakeholder interviews; Investor websites; Dalberg analysis

In general, sector selection has been fairly opportunistic rather than strategic, as investors are focused on finding investable companies irrespective of sector.

Faced with a dearth of investment-ready enterprises, investors are reluctant to restrict their portfolio to certain sectors. This has led to more capital flowing to sectors with investable companies. To date, these sectors are tourism and hospitality (there has been an investment in a hotel and interest in a restaurant, driven by the large number of foreign tourists visiting the country) and transport (there have been two investments in an airline).

Additionally, sector selection is often tied to ticket size. Investors who need to deploy large amounts of capital in individual transactions typically look for deals in sectors where enterprises can absorb large investments, including energy (particularly hydropower), and tourism and hospitality. While deal flow has been fairly limited, investors looking to make larger investments are expressing interest in these sectors (as discussed below). Agriculture in Nepal, in contrast, is still highly subsistence-based with little commercialization. Most investable opportunities in this sector are small in size and thus, do not appeal to DFIs or larger funds moving into the market. Instead, we see small funds investing in agriculture opportunities, with ticket sizes of USD 200,000 or less.

Although investments to date have been opportunistic with respect to sector, for the future investors are particularly excited about the potential of investing in hydropower, and tourism and hospitality. Historically, both these sectors have been high-growth sectors, and these trends are expected to continue. In addition, there have been a number of large hydropower projects that have brought on foreign investors, and IPO exits are more feasible, making it possible to list during construction to raise more capital. However, investors are growing wary of the hydropower sector, as regulations may tighten due to Indian investors looking to enter

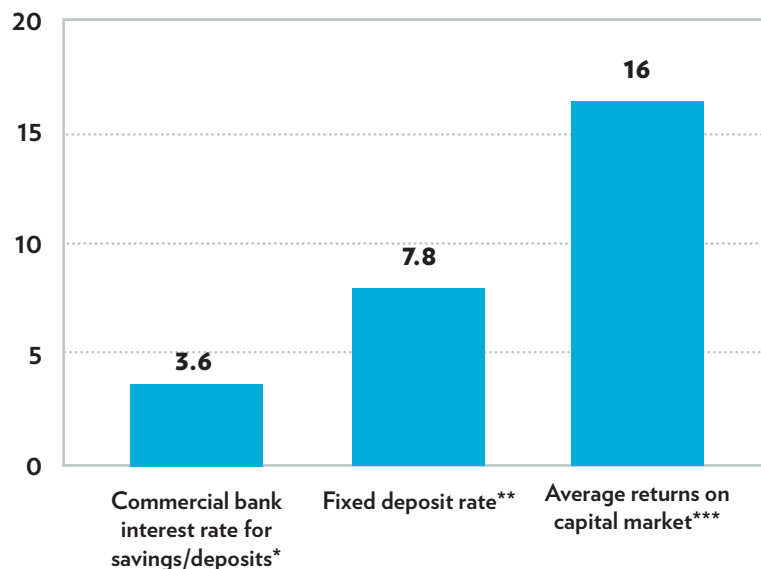
the market. Tourism and hospitality has also historically been a strong sector, and many investors are looking to invest in large hotel chains to capitalize on the growing number of foreign tourists visiting the country.

Outside of hydropower and tourism, sectors such as healthcare and education are growing in appeal due to remittance-funded spending for private services in these sectors. As remittance inflows continue to grow, provision of basic services is moving increasingly toward the private sector. Many families benefitting from remittance income are sending their children to affordable private schools and using private healthcare facilities, rather than the free public alternatives. Recognizing this trend, investors are increasingly interested in the for-profit entities coming into the market to address gaps in basic services.

Return expectations and exit possibilities

Return expectations range from 17% to 35% for equity investors, but with little market activity to date, these expectations are untested. Equity investors benchmark expectations against a high cost of capital (12%–13%) and the less-risky return expectations of the capital markets (16%–18%). Given the lack of exit activity among impact investors, return expectations are being calculated against returns on other asset classes (Figure 15).

FIGURE 15: APPROXIMATE RETURNS OF OTHER ASSET CLASSES (% ANNUAL)



Source: World Development Indicators, The World Bank; Nepal Rastra Bank; Stakeholder Interviews. Notes: *Interest rates have historically been volatile, making both depositors and investors wary. **Rate on 1-year deposits; lower rate offered used to calculate average, as of 2010. ***Market returns at 16%–18%.

Exits have been limited, among both impact investors and commercial investors.

Given the nascent commercial and impact investment markets, few investors have exited deals. The exceptions are hydropower projects, which have had a few exits through IPOs and, in turn, are driving greater interest in the sector. Interestingly, regulations allow for hydropower projects to be listed even before the project begins.

While equity investors would prefer exits via IPOs, it is more likely that exits will happen through secondary sales, trade sales, or owner buybacks. IPO is

preferred as investors believe that this exit option will yield the strongest returns. However, for now, the capital market is fairly small and not very vibrant. Additionally, the mandatory three-year post-IPO lock-in period (for investors holding equity stakes pre-IPO) is a key challenge that deters investors from making equity investments in the first place. Investors are hoping that IPO exits will be a feasible option by the time they are ready to exit as the capital market grows, but expect other exit mechanisms to be more likely. In particular, investors look at the large potential market in India as an exit option for both secondary sales to larger Indian funds and trade sales/acquisitions by Indian companies looking to expand.

Beyond the impact investing market

In addition to the eight impact investors, there is a peripheral group of impact-related investors that currently have investments worth USD 13.6 million. These investors include one small local fund making small ticket investments of between USD 2,000 and USD 8,000. There are also eight commercial banks using DFI capital to make SME loans. While this is a common activity of DFIs in the other countries under study, it has been limited by comparison in Nepal as DFIs are just entering the market and banks do not have the potential to reach many SMEs.

Debt is the preferred instrument among these investors, reflecting the large share of commercial bank lending to SMEs in this ring. Indeed, apart from only one USD 5,000 equity investment that has been made by a single investor, all investments in activity peripheral to impact investing have been deployed as debt.

While little is known about the individual portfolios of the commercial banks, it is likely that there is wide diversity in the sector, deal sizes are small, and investees are in the growth stage or are mature companies. Sector selection, ticket size, and growth stage preferences differ by lender. However, most lenders are sector agnostic; they look for investments that are financially viable in any sector. Therefore, there is likely to be some diversity in the sectors absorbing capital. Given that the loans are targeting SMEs, ticket sizes are small. Banks require an operating history, so it is likely that no seed (and minimal VC) funding is available. The other investor in this ring has also been making small deals and is opportunistic with respect to sector selection; however, this investor has only invested in venture stage companies as their capital needs are small (and match the fund's desired ticket size) and the fund manager has experience with companies in early growth stages.

Challenges facing impact investors in Nepal

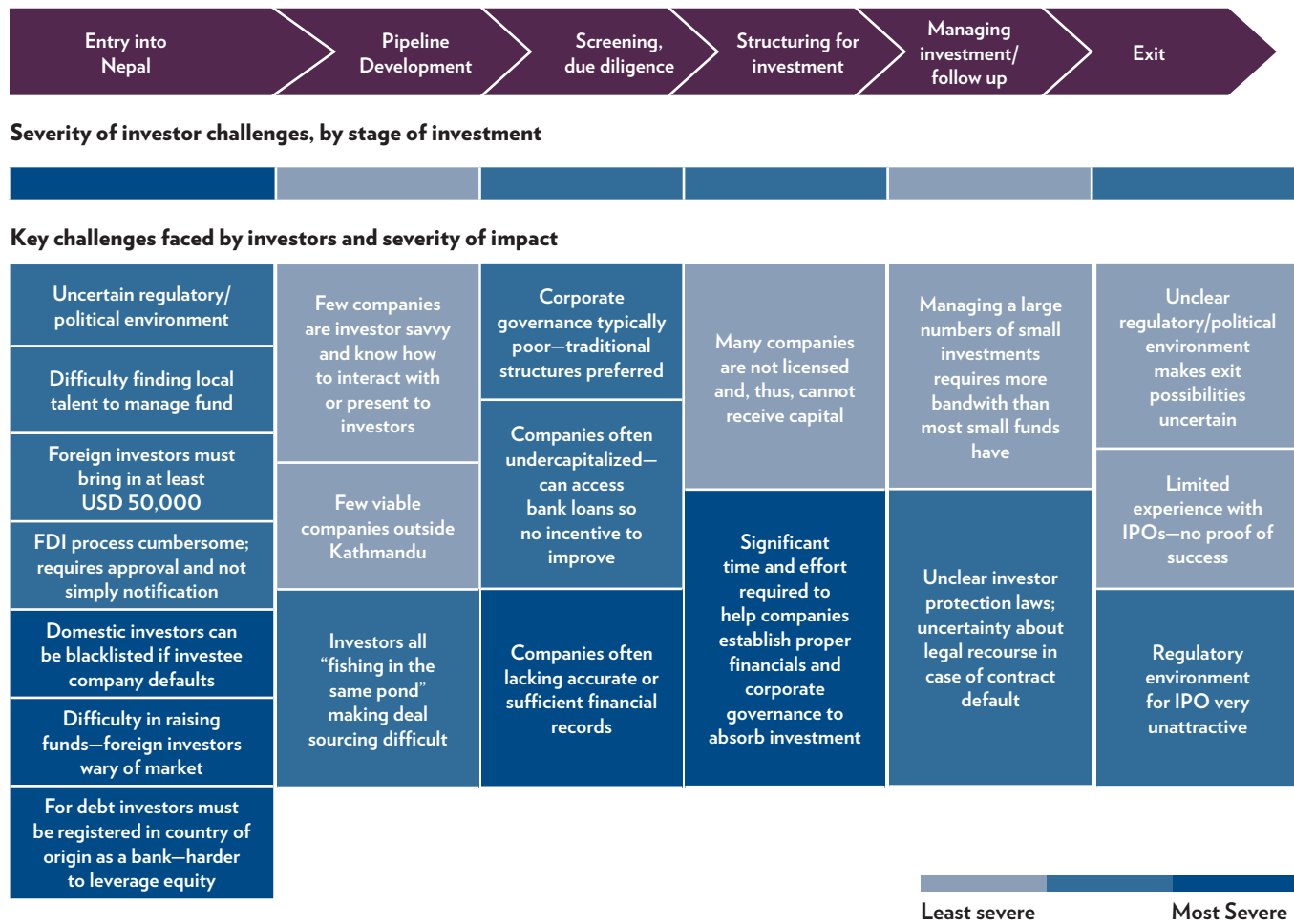
Looking across the investment cycle, investors struggle to get an initial foothold in Nepal due to cumbersome regulations (discussed further in the section titled “Enabling impact investing: the ecosystem”) as well as challenges in converting identified opportunities into investable deals (Figure 16). In the early stages of entering the market, investors face particular constraints navigating regulatory processes (particularly those related to registration and approvals) and identifying talented fund managers (since there is little history of PE/VC in Nepal, there are few experienced managers). Foreign investors face a cumbersome FDI process, which requires a minimum investment of USD 50,000 and pre-investment approval by certain authorities (rather than post-investment notification as in other markets).

Domestic investors, while not facing the same challenges, are subject to a “blacklisting” regulation that states that equity investors in a company that defaults or fails altogether are blacklisted in the financial markets, a threat that significantly lowers the investors’ risk appetite. Further, fund managers find it difficult to raise funds from both foreign and domestic investors who are uncertain of the potential in Nepal as illustrated in Figure 16.

In addition to restrictive or deterrent regulatory elements, the uncertainty and unpredictability of the application of regulations is additionally a deterrent.

For example, investors express that regulatory restrictions related to IPO exits are a barrier to investments—both in their official form and in the uncertainty of their enforcement. With a limited history of IPOs in the market, investors have no evidence of the viability of this exit option. Therefore, while defined on paper, there is no certainty that the regulatory process will be followed in practice. Furthermore, the regulations require a binding three-year lock-in period for investors following a listing and the premium valuation of shares is not allowed; instead, shares can only be listed at the present value.

FIGURE 16: CHALLENGES FACED BY INVESTORS AND ASSET MANAGERS ACROSS THE INVESTMENT CYCLE



Source: Stakeholder interviews; Dalberg analysis

In terms of pipeline development, while never an easy task, the small size of Nepal’s market in this case presents some advantages. The small market is made even smaller by the fact that most of the economic activity is concentrated in the Kathmandu Valley, and therefore most of the investible opportunities are concentrated there as well. On the flip side, this does at least make the identification of enterprises easier. While there is some level of “fishing in the same pond,” pipeline identification is possible through networking and relationship building as in most markets, and through alternative strategies such as working with commercial banks and other network points for enterprises.

However, the real challenge for investors in Nepal is getting identified enterprises to the point where the execution of a deal is possible. Above and beyond the standard due diligence, extensive and time-intensive work is needed to develop financial records and projections, business plans, governance structures, etc., as part of the deal-structuring phase. This can take months to achieve and requires significant hands-on investor engagement.

FIGURE 17: FUNDRAISING CHALLENGES FOR FUNDS AND FUND MANAGERS

<p>Difficulty raising funds and long fundraising timelines</p>		<ul style="list-style-type: none"> • One fund took approximately 2.5 years to raise USD 20 million and has been primarily funded by DFI/IFIs • One fund raised capital from a DFI, but was unable to raise any additional capital • The remaining funds have not raised capital, but are/were either self funded, funded by winnings from a business competition or pair HNWLs with investable businesses to facilitate investments from HNWLs to business
<p>Funds put on hold/closed</p>		<ul style="list-style-type: none"> • Two funds seemingly closed after poor performance and one fund was put on hold due to management issues • One fund has not yet deployed any capital, but has deals in the pipeline. Many investors (including DFI/IFIs) waiting to see how this fund performs before releasing or committing capital • DFI/IFIs have put investments on hold
<p>Challenges with foreign capital investments</p>		<ul style="list-style-type: none"> • Overseas funds are restricted to equity deals, because regulations require that debt providers be registered in their country of origin as a bank • The Government of Nepal is considering an increase in FDI minimum from USD 50,000 to USD 200,000 • Bringing in foreign capital is time consuming, difficult, and may require bribes be paid



Source: Stakeholder interviews; Dalberg analysis

Looking forward

Apart from the roughly USD 54 million capital that has been raised or committed to be deployed in the next 2-3 years, there are a few investors looking to raise additional capital for Nepal. While the size of these anticipated increases is much smaller than in other markets, these increases still represent a significant volume when compared to existing deployment. The investors will be a combination of DFIs and bilateral donors who are exploring the use of investment instruments to supplement their traditional grant-based financing. In fact, a few donors have expressed interest in anchoring investment funds or making direct investments. Finally, there is a small angel fund under consideration by existing Nepali investors that would meet a vital need for seed funding provided alongside technical assistance and mentorship.

In addition, a recently announced government program will provide USD 5 million to start-ups. No details are available on the program as yet. It is expected to take a year or more for the fund to open.

NEEDS AND OPPORTUNITIES: THE DEMAND SIDE

Overview of social enterprise ecosystem in Nepal

Like impact investing, the concept of impact enterprise, as defined by this report,⁵¹ is relatively new in Nepal, and very few enterprises have been started with an impact intention. Stakeholders suggest that a large proportion of enterprises in Nepal are focused exclusively on financial returns, but there has been a recent shift toward operating socially minded businesses. The shift is being driven by investors and consumers who are interested in supporting socially conscious companies and buying environmentally friendly products.

As a result of both the small size and the nascent status of the impact enterprise landscape as well as the broader concerns related to the market, we see very little impact capital directed into impact enterprises. Rather, investors deploy capital into SMEs or enterprises operating in sectors where, irrespective of the business model itself, the investors perceive an opportunity to broadly meet their dual social and financial mandates. In Nepal, these sectors have been hydropower—given the limited access to energy and large, untapped hydro potential in the country—and tourism, which is expected to generate significant economic growth.

Given the agricultural base of the economy, there are a large number of agricultural and agro-processing enterprises that seek to develop more inclusive supply chains. While for many entrepreneurs in the sector, “impact” was often not a core consideration in developing their businesses and business models, increasing awareness implies there may be a shift to explicitly incorporate social and environmental impact into the model once the enterprise is established.

While potentially an interesting target for impact capital, investors perceive two ongoing challenges: i) most enterprises are small scale as agriculture is mostly for subsistence and commercialization is still limited, and ii) while there are many enterprises in the sector, most are unused to external capital and the vast majority are outside the Kathmandu valley, making access and identification by city-based investors difficult.

Secondly, education and, to a lesser extent healthcare, are also attracting entrepreneur attention, driven by the potential market arising from remittance-fuelled disposable income. Early entrepreneurs in education have focused on lucrative private coaching centers and college/university prep centers, but a growing number are exploring the potential of low-income private schools, successfully drawing students out of the public system as families prioritize quality education with their increased incomes. While a similar trend could be possible in healthcare—as

⁵¹ For the purposes of this study, we define impact enterprises as those that have articulated a core objective to generate a positive social or environmental impact (as a part of their operating model rather than an ancillary activity), and seek to increase their financial viability and sustainability.

remittances increase incomes, populations become more discerning and willing to pay for private care—the regulations in the sector create relatively high barriers to entry. Therefore, impact enterprise activity in the sector may be slower to take off.

Energy is the third area that is increasingly seen as a growth opportunity for impact enterprises and therefore, for investors as well. Nepal offers massive untapped potential in the sectors of hydro and wind energy, and as the current energy demands are not being met, there is notable scope for innovative enterprise models to meet household needs. While experimentation and entrepreneurship in the sector are still limited, and the focus remains on relatively large-scale hydro plant development, there is potentially an opportunity for small-scale enterprise activity in the sector as well.

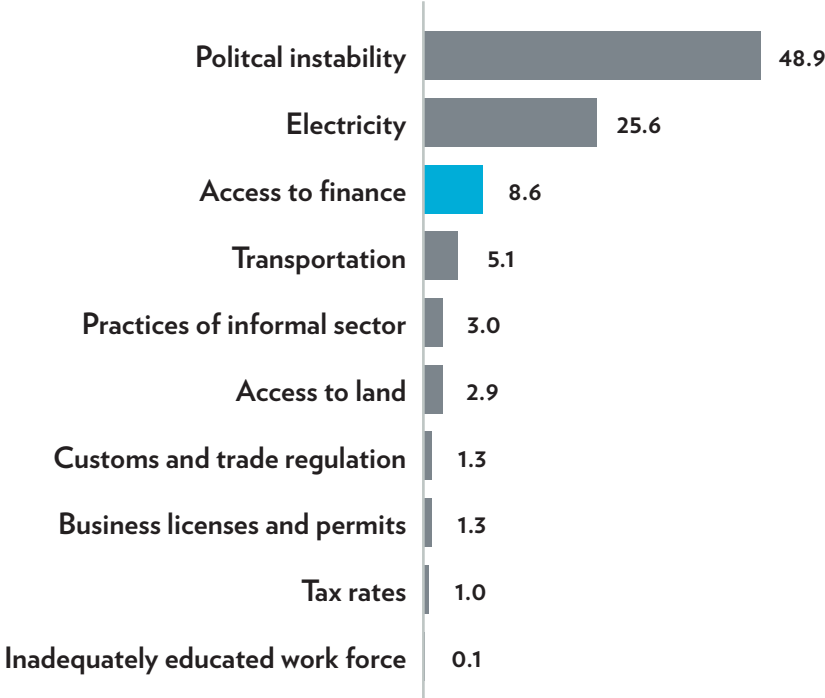
Ethically sourced handicrafts are a growing market, largely driven by foreign tourists. Handicraft stores in Kathmandu valley and other tourist spots are selling woven products, jewelry, and cosmetic and bath products produced using ethically sourced inputs. These retail stores often source directly from local women's cooperatives that manufacture the products. The market is largely driven by foreign tourists.

That said, while opportunities are certainly visible in the market, the low level of familiarity with the impact enterprise concept means that thus far, there has been little innovation in the space. Some investors believe that once impact-oriented funds become more active and start to target and develop viable impact enterprises, the awareness and attractiveness of the model will grow; entrepreneurs that may have been operating with dual social and economic objectives without explicitly defining as such may start to rearticulate their models and new approaches may be developed.

Constraints to enterprise growth

As shown in Figure 18, access to finance is the third biggest constraint to growth in Nepal, preceded only by political instability and access to electricity. Power access is particularly important for enterprises in manufacturing industries where the key issues are related to reliability and consistency, given the context of heavy load shedding in Nepal, rather than connectivity or access itself.

FIGURE 18: ENTERPRISE CHALLENGES (PERCENTAGE OF RESPONDENTS IDENTIFYING A CERTAIN CHALLENGE AS THE LARGEST CONSTRAINT TO BUSINESS)



Sources: IFC Enterprise Survey of 482 enterprises in Nepal; Stakeholder interviews; Dalberg analysis

The access to finance constraint is driven by multiple sub-factors (Figure 18).

For business managers, access to capital (rather than its availability) is often the more pressing issue. In particular, many enterprises do not know where to look or how to identify sources. Often, the capital available is not appropriate for the needs of business managers, and the process of obtaining capital also prevents access. For instance, the low level of innovation in bank products means a poor fit for enterprise needs: no bridge loans or project finance products are available, and working capital loans are only given against stock (which may not exist in the early stages).

Like investors, entrepreneurs also face certain challenges while raising finance in the capital markets as they are similarly dissuaded by the regulatory conditions.

As discussed previously, regulations in Nepal require a three-year lock-in period for investors and prohibit the premium valuation of IPOs. As such, business managers have little incentive to list shares on the public market.

As expected, we see that the extent and manifestation of these challenges vary by enterprise growth stage.

Seed stage enterprises can often, although not easily, access capital through microfinance or informal channels. Therefore, it is after the initial injection and before the company is fully profitable or with stable revenues that the greatest constraints are felt.

FIGURE 19: SEVERITY OF ACCESS TO FINANCE CHALLENGES FOR BUSINESS MANAGERS BY ENTERPRISE GROWTH STAGE



Severity of access to finance challenge, by stage of growth



Key challenges faced and severity of impact

Identifying sources of capital

Limited formal sources of capital for early stage; most seed funding from friends and family	For large loans, banks prefer only to loan to companies with whom they are familiar or have a lending history	
Few domestic investors take equity stakes in private companies; they either invest equity in enterprises within their own networks (which are easy to vet) or they invest in public equity markets		
Many entrepreneurs are wary of banks due to belief that bank employees may steal business idea	International investors not interested in or cannot enter Nepal market	Small capital market with mostly banks listed
Outside of banks, there are a minimal number of capital sources present in the country		
Banks do not reach a large portion of the population		

Appropriateness of capital

Low levels of understanding among business managers of non-debt instruments and appropriateness of instrument given needs/stage (e.g., debt in early stages can be crippling due to interest repayment)		Regulations inappropriate—act as a deterrent or disincentive (e.g. 3-5 year lock-in period, no premium valuation)
	Uncertainty about legal recourse available if issues arise with equity investor	
Tenure of bank loans not appropriate—in early stages need long term loans with long grace periods before company is revenue positive		High levels of volatility in interest rates can be crippling and reduce ability to repay
Low levels of innovation in bank products means poor fit for enterprise needs—e.g. no bridge loans or project finance products, working capital loans only given against stock which doesn't exist in the early stages, etc.		

Accessing capital

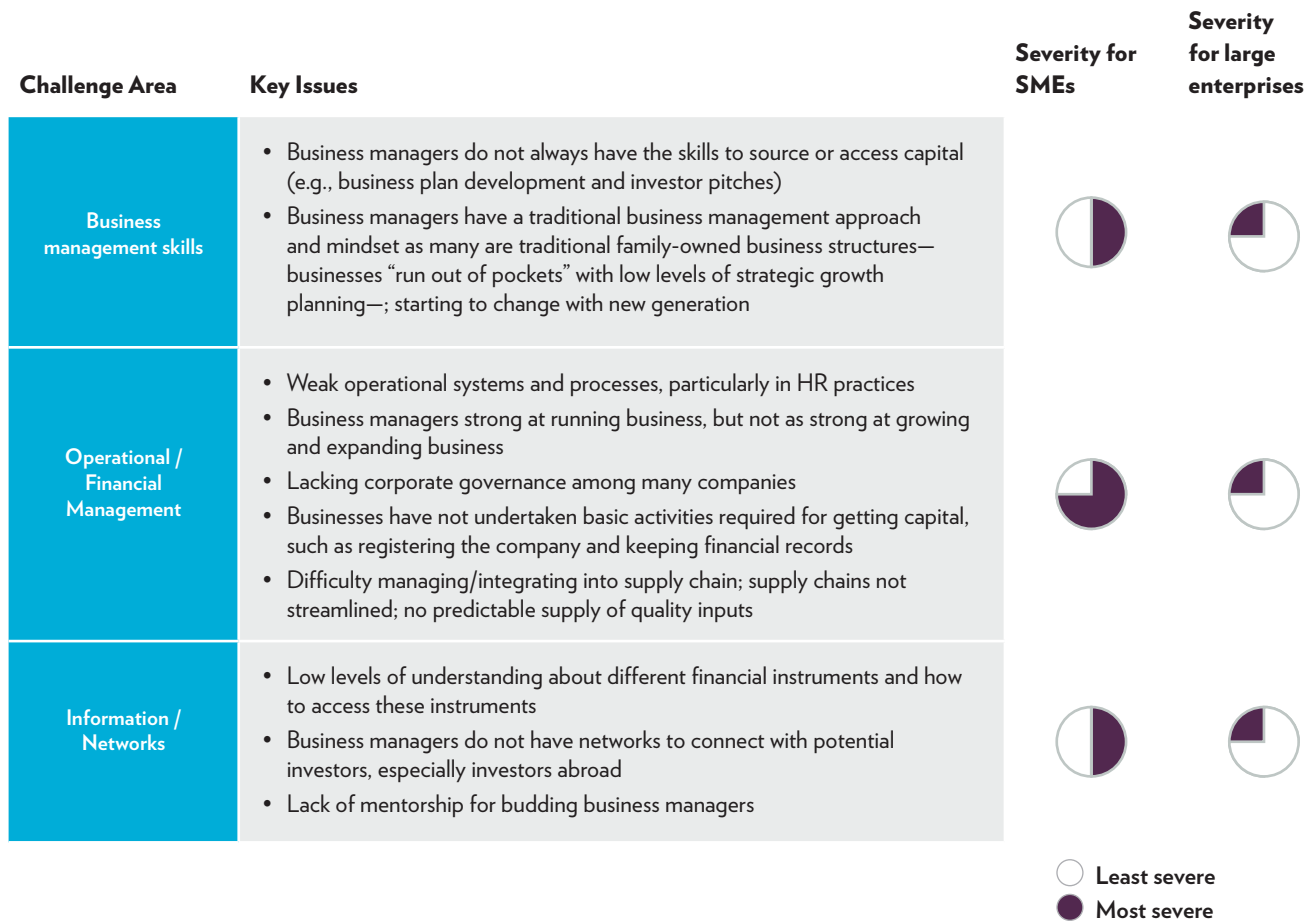
Complicated process of applying for capital and negotiating terms of investment, due to lack of investment-related experience		Uncertainty about IPO process and perceptions of restrictive nature
Difficult to secure reliable third party valuation; enterprises themselves don't understand or have the capability		
Companies have not kept accurate financial records (by design to avoid taxes or by default due to lack of knowledge) and investors require 1+ years of operating records		Owner can only sell to other owner—limits ability to exit through IPO
Collateral requirements are high, too high for new/young enterprises; entrepreneurs often take personal loans or use unregulated financial institutions, both of which have higher interest rates		
Working with foreign investors is more difficult due to cultural mindset—perceptions of how things should work based in home country are different		

Source: Stakeholder interviews; Dalberg analysis



In addition to limited access to finance, enterprises struggle to grow due to lack of business and management skills—a gap identified by entrepreneurs, investors, and ecosystem players. In particular, for SMEs, the low levels of operational and financial management skills are a significant constraint to growth, particularly around financial record keeping and planning, HR management, and supply chain management.

FIGURE 20: KEY CONSTRAINTS FACED BY ENTERPRISES OF DIFFERENT SIZES



Source: Stakeholder interviews; Dalberg analysis

ENABLING IMPACT INVESTING: THE ECOSYSTEM

The two broad dimensions of the ecosystem to consider are the macro investment climate (including considerations such as ease of doing business, political stability, macroeconomic governance, infrastructure strength and reliability, and the regulatory framework) and the specialized support available for investors and enterprises for navigating the investment landscape (such as deal sourcing and matchmaking, and enterprise development).

The macro investment climate

The macro climate for investors has been improving slowly along certain dimensions, but in general, it remains fairly unattractive. While ranking fairly highly in our study country set (lower than Sri Lanka and India but higher than the rest), overall, Nepal ranks 105 out of 189 countries in the World Bank “Doing Business” rankings. Nepal scores relatively high on protecting investors with a ranking of 80 and the ease of starting a business rank improved from 103 to 97 between 2013 and 2014.

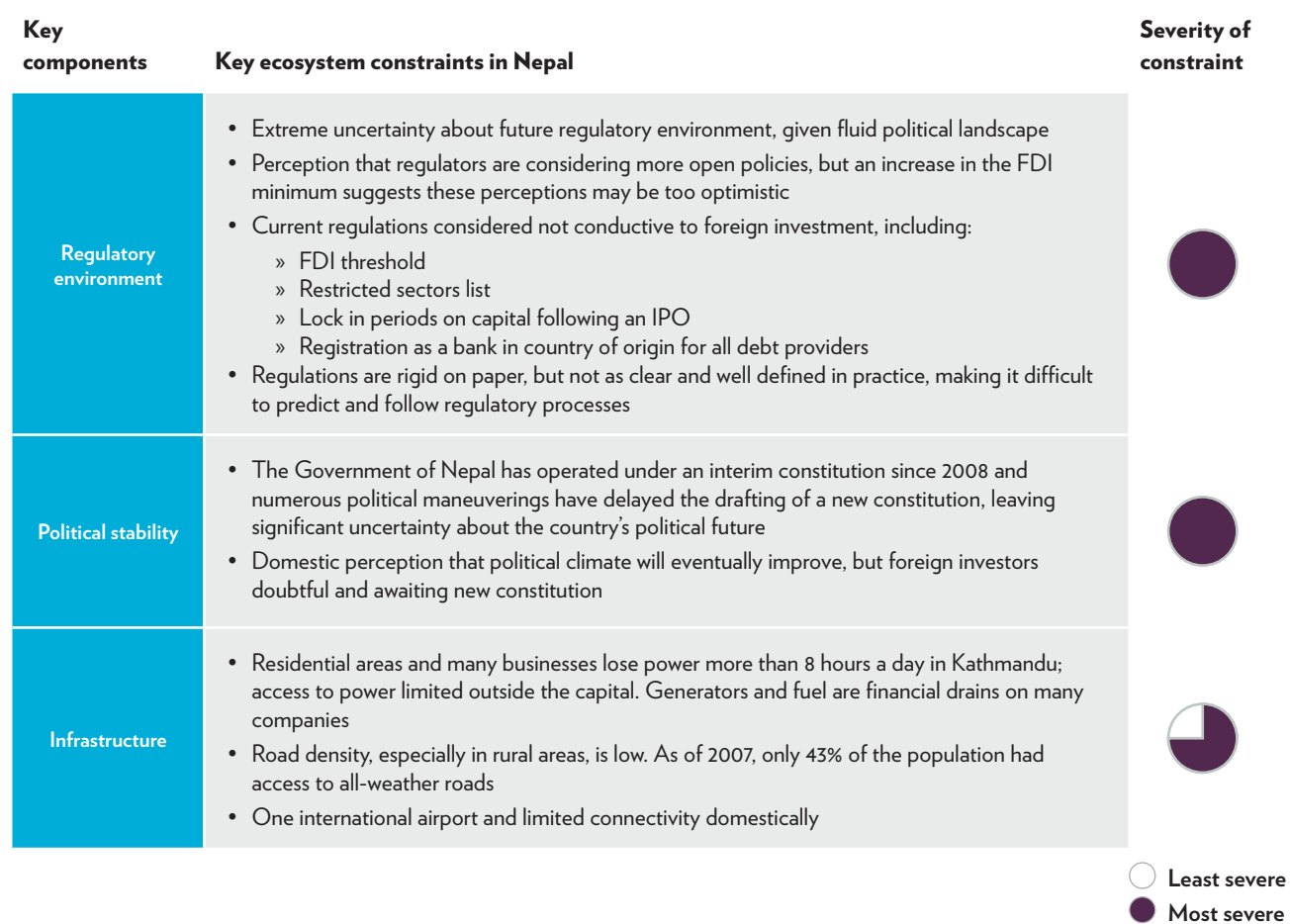
Investors and entrepreneurs are optimistic that shifting political conditions, and a new constitution (currently under negotiation) will open markets and lead to more liberal policies and regulations. However, delays in the political process to date leave them uncertain of when the changes will come and exactly how positive these changes will be. In the meantime, a variety of regulations reduce the appeal for investors or prevent entry altogether. Some of these regulations have been discussed previously and are highlighted below.

- ✓ Foreign investors must bring at least USD 50,000 for investment, and the government is considering raising this threshold to USD 200,000.
- ✓ Foreign investors must gain approval from the Department of Industries for all equity investments. For new equity investors, the process requires additional registration and approvals.
- ✓ A foreign investor providing debt must be registered with the appropriate officials as a bank in their country of origin, and the loan must also be approved by the Department of Industries.
- ✓ Foreign investors are restricted from investing in 21 sectors under the Foreign Investment and Technology Transfer Act of 1992. However, the current list is under review and a new policy seeks to reduce the number of sectors restricted to foreign investment from 21 to seven. Sectors that are likely to remain restricted under the amended framework include real estate and housing (excluding construction), hotels that have a ranking of less than three stars, multi-brand retail businesses with investments of less than USD 50,000, cottage industries, arms and ammunition, and coins and currency.

- ✓ Domestic investors can be blacklisted from financial markets if they hold equity in a company that fails. Foreign investors were recently exempted from this regulation.
- ✓ The Securities Registration and Issue Regulations Act requires that pre-IPO investors are locked in for a period of three years following a public listing.
- ✓ Upon public listing, no premium valuation of shares is allowed.

Perceptions of political and policy instability are compounded by the weak infrastructure—particularly, power and road infrastructure. Although nearly 80% of the population has access to electricity, power is unreliable, with residential and business areas losing power for up to eight hours a day. Many businesses are forced to use generators, which are a financial drain. Meanwhile, poor road conditions make it difficult to access areas outside Kathmandu—disrupting supply chains, increasing the cost of travel and shipping, and making it difficult for investors to scope for companies outside the Kathmandu valley.

FIGURE 21: SEVERITY OF INVESTMENT CLIMATE CONSTRAINTS IN NEPAL



Source: Stakeholder interviews; Ministry of Industry “Invest Nepal” and policy documentation; Nepali news reports; Dalberg analysis

The general perception is that the new government and the heads of key bureaucratic divisions are pro-private sector and will institute business-friendly reforms. However, the key question for investors and entrepreneurs is related to the pace of such reform, and the perception is that although positive, the change will be slow.

There are three institutions leading the efforts to improve the investment climate (in partnership with donors and DFIs): the Nepal Investment Board, Nepal Rastra Bank, and the Securities Board of Nepal. While investors seem to believe that all three regulatory bodies are pro-private sector growth and thus, investment-friendly, there are varying degrees of belief in these bodies' ability to address the existing gaps in policy (Figure 22).

FIGURE 22: ROLE, MANDATES, AND PERCEPTIONS OF THE THREE KEY REGULATORS



<p>Nepal Investment Board</p>	<ul style="list-style-type: none"> Established under the Investment Board Nepal Act in 2011 Promotes economic development by creating and ensuring an investment-friendly climate Functions include mobilizing and overseeing investments, setting investment priority areas, selecting investment projects 	<ul style="list-style-type: none"> Perception that Nepal Investment Board is supportive of private sector development and improvements to investment climate Able to interface with foreign investors
<p>Nepal Rastra Bank</p>	<ul style="list-style-type: none"> Founded in 1956 under the Nepal Rastra Bank Act Monetary, regulatory and supervisory authority of banks and financial institutions Functions include regulating and overseeing banks, monitoring economic situation, promoting financial services and setting monetary policy 	<ul style="list-style-type: none"> Perception that bank is aware of policy gaps and willing to address these gaps Uncertainty about the future direction of Bank policy, given shifting political climate and new constitution Process is expected to take time (One year to sign new constitution) Perception that there are very low levels of understanding about new financial instruments, leading to difficulty in regulating instruments they don't understand Concern about bureaucrats' ability to work with foreign investors
<p>Securities Board of Nepal (SEBON)</p>	<ul style="list-style-type: none"> Set up in 1993 under the Securities Act Registers securities; regulates sale, transfer and exchange of securities; supervises and monitors stock exchange; supervises investment funds and grants permission for their activities 	<ul style="list-style-type: none"> Appear supportive of regulatory changes that promote investment and private sector development Concern about bureaucrats' ability to work with foreign investors



Source: Stakeholder interviews; Dalberg analysis

Support for investors and enterprises

There are a growing number of service providers for investors and enterprises, but this support is not sufficient or advanced enough. Little is known about the changing regulatory environment, and there is no support for investors navigating the regulations. No “one-stop shop” exists to support investors with navigating the process of registering.

FIGURE 23: CONSTRAINTS TO INVESTOR AND ENTERPRISE SUPPORT IN NEPAL

Investor and Enterprise support	Key components	Key ecosystem constraints in Nepal	Severity of constraint
	Investor support	<ul style="list-style-type: none"> • Little is known about the changing regulatory environment and there is no support for investors navigating the regulations • DFI/IFIs and large funds advocating to regulators/policymakers on behalf of investors • No local providers of investor support, but many fund managers are expats or have worked/been schooled abroad and have a strong grasp of the financial sector • No “one stop shop” for investors to register—e.g. Department of Industry approves FDIs, Central Bank approval, etc.—and no assistance provided to navigate process 	
	Enterprise support	<ul style="list-style-type: none"> • In addition to access to finance challenges, entrepreneurs face a range of other constraints to growth including their own business mindset, skills and knowledge, as well as access to information and networks • Given the small market size in Nepal, there are quite a few providers of business support services, but these providers are typically small and new to the space • Key areas of need include: <ul style="list-style-type: none"> » Aggregation/networking/knowledge sharing amongst entrepreneurs » Training in key business management functions—both strategic and operational 	

 Least severe
 Most severe

Source: Stakeholder interviews; Dalberg analysis

While there has been some history of donor programs (including some run by Gesellschaft für Internationale Zusammenarbeit (GIZ) and Stichting Nederlandse Vrijwilligers (SNV)), private players are only just starting to enter the enterprise development or support landscape and very few are well known or easily accessible. Given the current focus on improving the investment climate and regulatory environment, there has been a heavy emphasis on institutional capacity building and policy advocacy. As a result, enterprise development support has not been emphasized as heavily, although there is recognition now of the severe need in this area with the emergence of private providers.

FIGURE 24: EMERGING PLAYERS IN ENTERPRISE SUPPORT LANDSCAPE IN NEPAL

Incubators/Accelerators



Advisory Services



Credit Rating Services



TA Providers



* Has not yet started but is in final fundraising and should host first cycle this year

Sources: Stakeholder interviews; Dalberg analysis

While the ecosystem seems to be evolving and growing, it is not yet sufficient to address the needs of entrepreneurs and investors in the market. Investors hope that a new constitution will bring about regulatory structure and certainty, kick-starting the investment market and enabling continued growth.

AREAS FOR FURTHER RESEARCH

As Nepal represents a still-maturing impact investing landscape, there exists scope for additional research to highlight key opportunities in the country. First, in addition to determining what innovations in financial products are optimal for a nascent enterprise and investing market, further insight on what will make the market more attractive overall, would be beneficial. Investors from abroad are not yet very interested in the Nepal market, given the country's small population, small GDP, and a very small number of companies that can actually absorb capital. Furthermore, exposure to financial services and investor experience in Nepal is limited. Given a very young and not fully supportive overall ecosystem for impact investing, further research can highlight how to catalyze impact enterprise growth, increase investor knowledge and experience in-country, and pinpoint areas of interest for foreign investors.

Second, most of what is known about the impact investing market in Nepal reflects what is happening in Kathmandu only and not the activity outside this region. A greater understanding of what is happening in the surrounding areas would be helpful to the investors.

Third, further study in specific sectors of interest, including tourism and hydropower, to estimate the financial performance and impact of historical activities, will provide lessons that will guide the market growth.

Lastly, specific research on the effect of remittances from abroad on the private uptake of traditionally public services would be interesting. For example, there are several start-up enterprises that provide basic services, such as water, sanitation, healthcare, and education. Families in Nepal can, to a large extent, consume these services because of their remittance income, which is a significantly high percentage of the country's GDP. If foreign nationals further develop an interest in investing in small enterprises, remittances may begin to fuel investments in growing start-ups in Nepal, as a trend.

PAKISTAN



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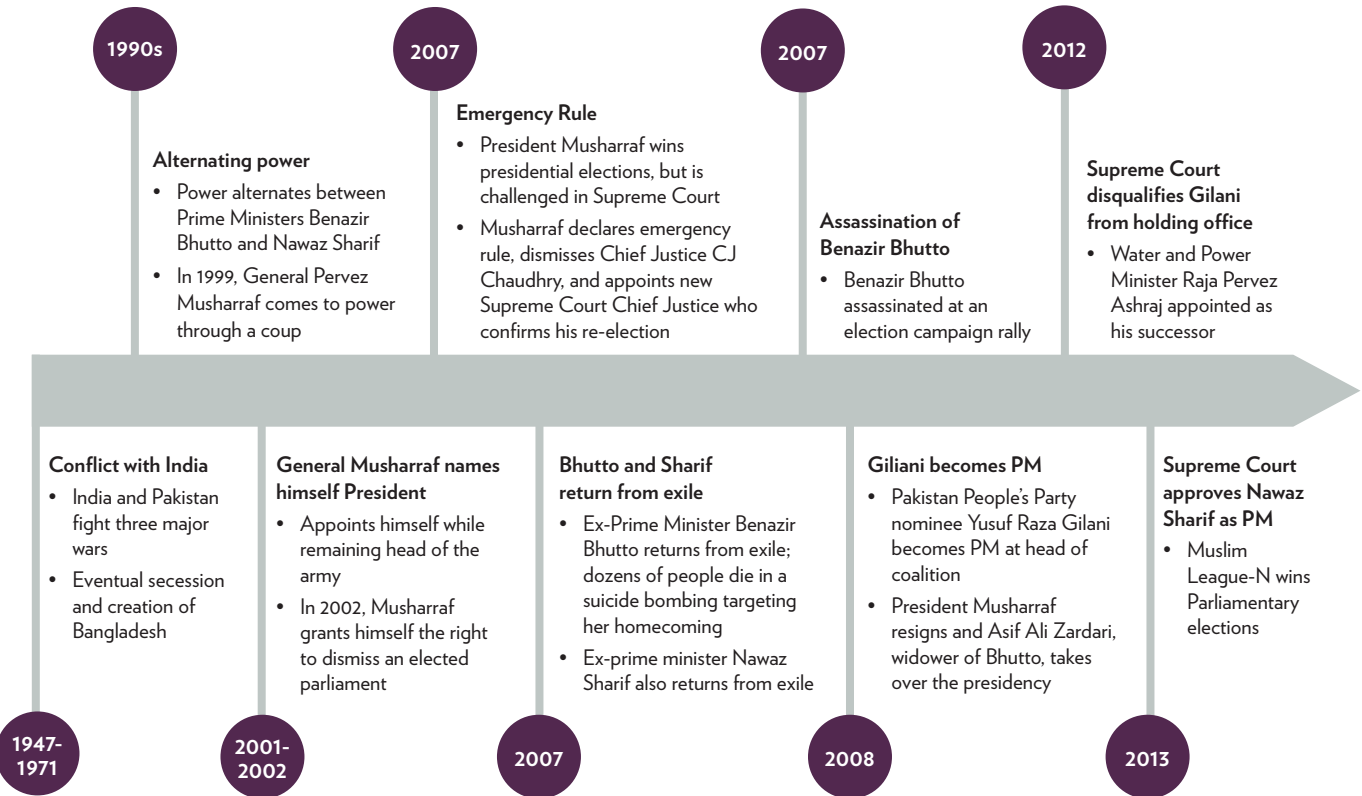
COUNTRY CONTEXT

Overview

Pakistan is a young country but has had a tumultuous political history with numerous regime changes including martial rule, dictatorships, and democracy.

Between 1947 and 1971, India and Pakistan fought two major wars over Kashmir, setting Pakistan up for several years of political churn. In 1999, General Pervez Musharraf came to power through a military coup, remaining in power for almost ten years. Between 2008 and 2013, Pakistan again saw several political changes. These included President Musharraf's resignation in 2008 following impeachment proceedings against him, and the election of Asif Ali Zardari (the widower of former Prime Minister Benazir Bhutto, who was assassinated in 2007), as well as reform efforts in 2010 when the parliament approved wide-ranging constitutional reforms (including the transfer of key powers from the Office of the President to that of the Prime Minister). Prime Minister Nawaz Sharif's parliamentary election in 2013 marked the first time an elected government successfully completed its term in office and handed power to an elected successor. The new government is widely considered to be pro-private sector and business friendly, and this is encouraging for investors—a necessary boost after decades of instability serving as a strong deterrent.

FIGURE 1: TIMELINE OF PAKISTAN'S POLITICAL HISTORY



Sources: BBC Pakistan Profile <<http://www.bbc.com/news/world-south-asia-12965779>>; Insight on Conflict <www.insightonconflict.org>;

In addition to political instability, the most significant deterrent for investors is the perceived insecurity or the volatility of the security situation in the country.

Pakistan has been marred by terrorist attacks and sectarian violence. Despite government attempts to fight terrorism, threats remain high. Since 2001, terrorism inside Pakistan has increased twofold, where in addition to sectarian violence, Pakistan has had to combat the threat of Taliban militants and the Al-Qaeda. According to President Zardari, between 2001 and 2011, militant attacks killed 35,000 people in Pakistan (including 5,000 law enforcement personnel) and caused material damage worth USD 67 billion.⁵² According to the South Asia Terrorism Portal (SATP) database, between 2003 and September 2014, there were 18,389 civilian and 5,917 security force personnel fatalities due to terrorist violence.⁵³ These attacks have targeted both local and foreign interests, including physical and human resources for the United States' "war on terror," establishments frequented by westerners, direct interests of the Pakistani army, numerous prominent Pakistani politicians (some of whom were assassinated), key infrastructure (including airports and courts), and various ethnic and religious minority groups.

52 *Express Tribute, Islamabad, Kabul look inwards as Tehran blames US, 2011.*

53 *South Asia Terrorism Portal, www.satp.org, accessed: September 17, 2014.*

GDP growth and drivers of foreign direct investment (FDI)

Security concerns greatly undermine investor confidence and deployment of foreign capital into Pakistan; investors have reacted strongly to significant changes in the political environment (see Figure 2). For instance, a rapidly

worsening security situation in 2007 and 2008 (imposition of emergency rule and the siege of a major mosque by a terrorist group) preceded a dramatic decrease in FDI inflows in 2008 and 2009.

Although security concerns remain an issue, the introduction of pro-business and private sector measures as of 2012 under Prime Minister Sharif's government have resulted in increased FDI in the country. The new government has taken several measures to improve the ease of doing business in Pakistan, particularly with respect to investor protection and starting a business. Moreover, the government has launched fiscal and structural reforms (supported by the International Monetary Fund (IMF)) to address macroeconomic challenges and energy shortages, and to steer the economy towards faster and more sustainable growth⁵⁴ (refer to the “*Enabling impact investing: The ecosystem*” section for more details on the regulatory environment).

FIGURE 2: FDI NET INFLOWS INTO PAKISTAN (CURRENT USD MILLIONS)



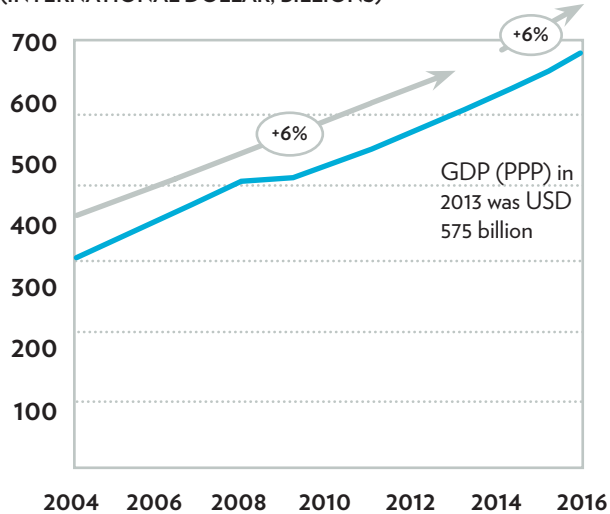
Source: World Development Indicators, The World Bank

⁵⁴ ADB, Asian Development Outlook 2014, Manila, 2014.

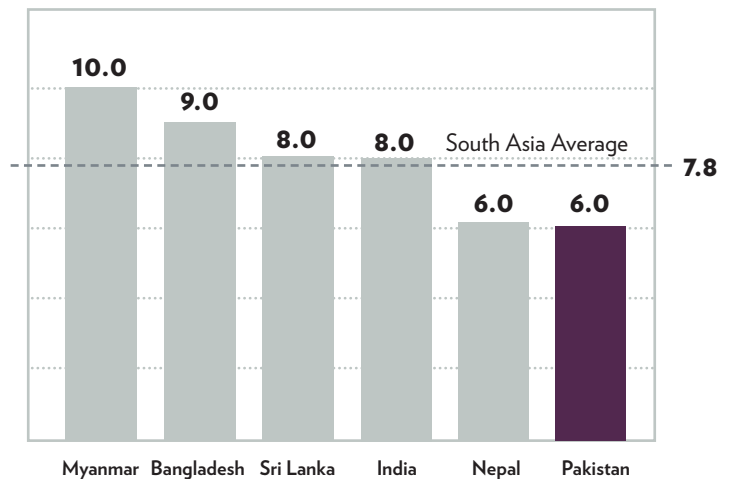
Pakistan's forecasted GDP growth rate is predicted to be one of the lowest in the region. The key drivers of Pakistan's low projected growth are continued security concerns and the need for structural reforms in the areas of energy, taxation, and state-owned enterprises.⁵⁵ Accelerating growth will be challenging without improvements in the security situation and without addressing these regulatory and infrastructural challenges.

FIGURE 3: PAKISTAN GDP (PPP) OVER TIME AND FORECASTED 2015 GDP GROWTH RATE FOR THE REGION

PAKISTAN GDP, PURCHASING POWER PARITY
(INTERNATIONAL DOLLAR, BILLIONS)



FORECASTED GDP GROWTH RATE
(% P.A., 2014 TO 2016)

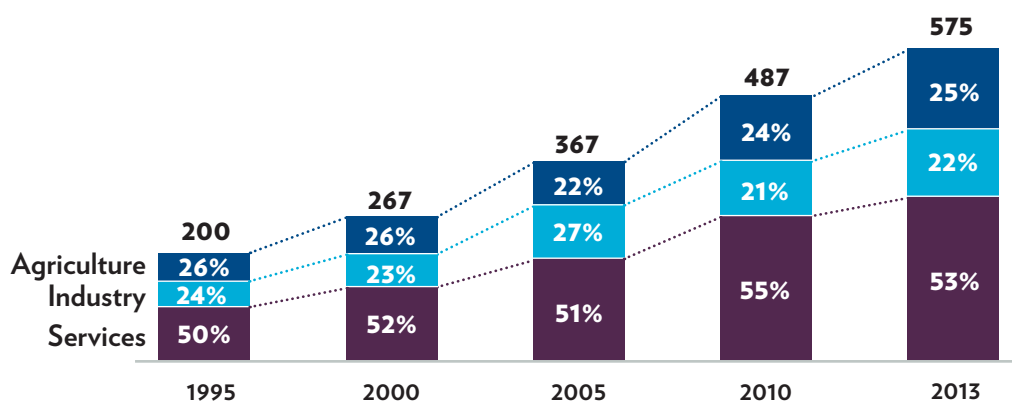


Sources: World Development Indicators, The World Bank; IMF estimates; Dalberg analysis; The Express Tribune (2014)

55 ADB, Asian Development Outlook 2014, Manila, 2014.

The distribution of sector contribution to GDP has remained relatively unchanged over the years, with services contributing the most to Pakistan's GDP growth. Despite agriculture's small share of contribution to GDP (25% in 2013), it employs more than 40% of Pakistan's labor force, while the services sector, which makes up the most sizeable contribution to GDP at 53% in 2013, employs around 30% of the labor force.

FIGURE 4: SECTOR CONTRIBUTION TO GROWTH AS PERCENTAGE OF GDP (PPP, INTERNATIONAL DOLLAR, BILLIONS)



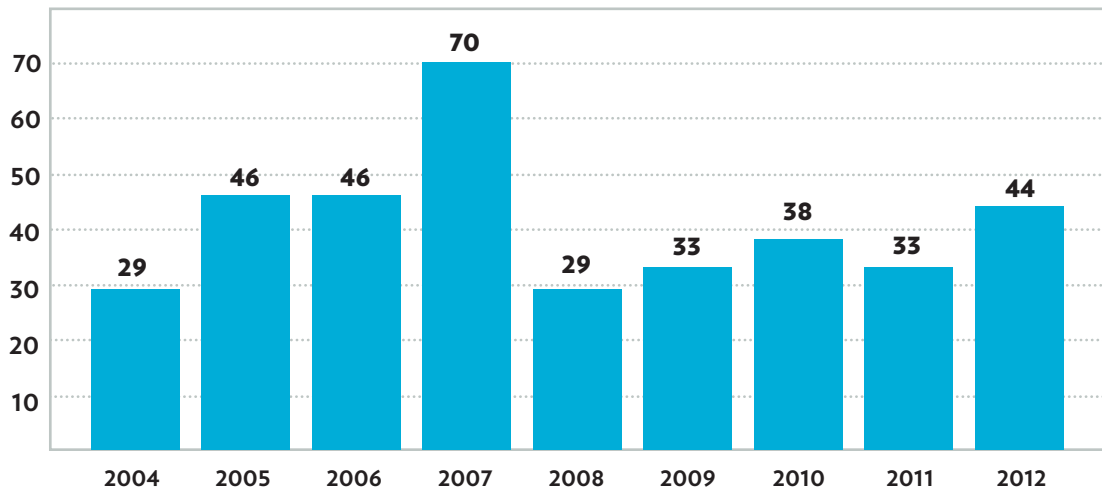
Sources: World Development Indicators, The World Bank; IMF World Economic Outlook; Dalberg analysis

In addition to GDP growth, the capital markets are slowly recovering after a drastic decline in 2008. Pakistan has three stock exchanges, namely Karachi, Islamabad, and Lahore. Market capitalization grew from USD 33 billion to USD 44 billion in 2012⁵⁶ (See Figure 5). Moreover, despite violence and a worsening security situation, there was overall growth in market capitalization between 2004 and 2012 due to a wide range of economic reforms launched in 2000, including fiscal adjustment, privatization of energy, banking sector reforms, and trade reforms. In addition, low interest rates, high liquidity, and strong external demand helped Pakistan's growth. Moreover, concessional external assistance and debt restructuring (including that from the World Bank) played a significant role as did increased support provided by the US post-September 2011.⁵⁷

⁵⁶ World Development Indicators, The World Bank (2008–2012).

⁵⁷ World Bank, Macroeconomics and economic growth in South Asia: Growth in Pakistan.

FIGURE 5: TOTAL MARKET CAPITALIZATION OF LISTED COMPANIES (CURRENT USD BILLIONS)



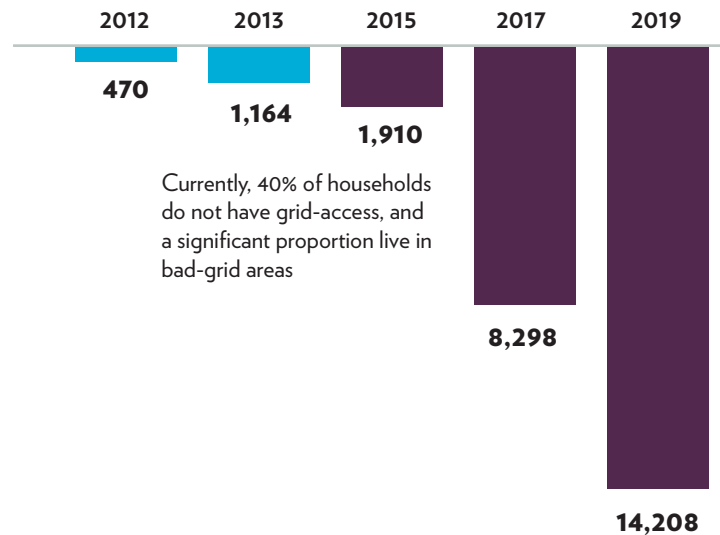
Source: World Bank Development Indicators

Key constraints in Pakistan

Energy shortages, in addition to security concerns, remain one of the most significant challenges to investment. Currently, more than 30% of all households are un-electrified,⁵⁸ while a significant proportion of Pakistan's population is under-electrified. Access to energy is a particular concern for the manufacturing industry for which consistent, reliable, and affordable power is a key driver of competitiveness. Investors report low interest in heavy manufacturing sectors due to the high costs of such access to energy.

⁵⁸ World Development Indicators, The World Bank.

FIGURE 6: PAKISTAN'S PROJECTED POWER GENERATION DEFICIT, HISTORIC AND FORECASTED (MW)



Sources: Oracle Coal Fields, Country Overview

Given the projected deficit, the government and the private sector are now trying to directly address the access to energy challenges. The government is undertaking the construction of more power plants, using both renewable (e.g., wind and hydro-power) and non-renewable energy sources, in addition to providing cash and bonds⁵⁹ to independent power producers to enable them to clear their outstanding debts and generate additional power.⁶⁰ Moreover, given the market opportunity to serve consumers in off-grid and under-electrified regions, there is an increasing interest in the development of enterprise models to serve the energy needs of these areas.⁶¹

Overall, despite concerns about security challenges and energy shortages, Pakistan's large population, growing middle class, and increasingly favorable regulatory investment environment remain strong foundations for attracting investors. The large domestic market creates a strong demand and opportunity and is expected to grow with the expansion of the consumer class. Similarly, the regulatory environment has been improving since 2000. For example, today, fewer approvals, permits, and licenses are required from several different government entities to launch a business in Pakistan.⁶² Overall, while Pakistan's World Bank "ease of doing business" rank of 128 is below that of Sri Lanka's (99) and Nepal's (108), Pakistan scores higher than both India (142) and Bangladesh (173).

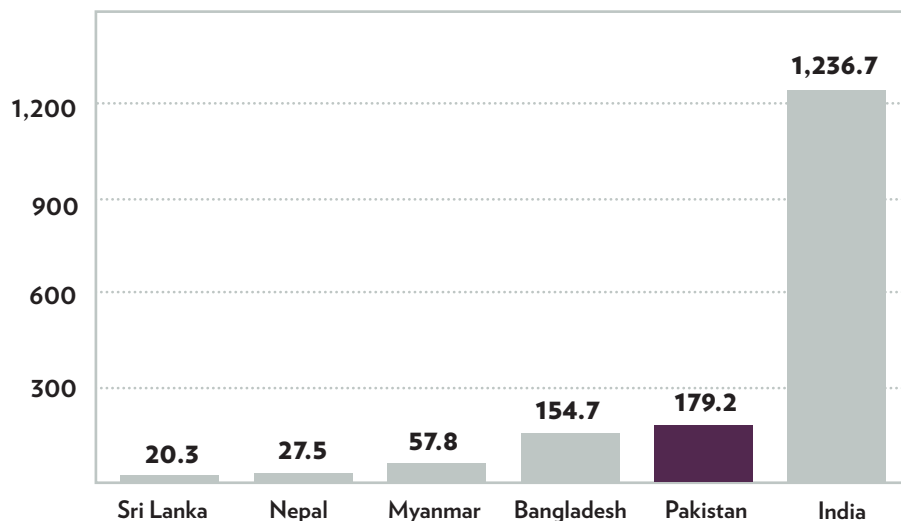
⁵⁹ *The Diplomat*, Pakistan's energy crisis, 2013.

⁶⁰ *State Bank of Pakistan*, Annual report, 2012.

⁶¹ *Dalberg*, Stakeholder interviews

⁶² *US Department of State*, Investment climate statement, Pakistan, 2014.

FIGURE 7: POPULATION OF PAKISTAN AND REGIONAL COMPARISON (IN MILLIONS, 2012)



Source: World Bank Development Indicators

Despite this relative regulatory strength, public service provision in Pakistan remains poor, as evidenced by its low performance on key social indicators.

Pakistan’s human development index score of 0.52 is below the South Asia average of 0.56,⁶³ life expectancy at birth is relatively low at 65.7 years,⁶⁴ and infant mortality is high at 69 per 1000 live births,⁶⁵ which are all indicative of a weak healthcare system.⁶⁶ Similarly, in the education sector, with almost 5.5 million children that are out of school, Pakistan has the second highest number of out-of-school children in the world, after Nigeria.⁶⁷ Literacy rates are low and skewed by gender: 50% for women and 69% for men.⁶⁸ According to UNESCO’s 2014 Global Monitoring Report, Pakistan is among the 21 countries facing an extensive “learning crisis” due to academic performance, literacy, enrolment, and dropout rates.⁶⁹

63 The human development index examines life expectancy at birth, expected and mean years of schooling, and GNI per capita.

64 UDDP, Human development index, 2013 (2012 data).

65 UNICEF, Pakistan statistics, basic indicators, 2012.

66 World Development Indicators, The World Bank (2013)

67 UNESCO, “Teaching and learning: Achieving quality for all,” EFA Global Monitoring Report, 2014.

68 World Economic Forum, The global gender gap report, 2013.

69 Op Cit. UNESCO, EFA global monitoring report, 2014.

INVESTING IN PAKISTAN: THE SUPPLY SIDE

The broad impact capital market in Pakistan

In spite of the perceptions of extreme volatility and insecurity, Pakistan has one of the largest impact investment landscapes in the region. More than USD 1.8 billion has been deployed into Pakistan by DFIs, while a further USD 162 million has been deployed by other impact investors.

The key advantages that investors perceive in the Pakistan market include the large domestic market and the resulting investment opportunity with a strong return potential, favorable regulatory environment (although there are some concerns related to the regulation of the private equity (PE) industry, as will be described subsequently in the section “*Challenges facing impact investors in Pakistan*”), an extremely strong local entrepreneurial culture, and a relatively large and deep pool of talent from the well-educated, internationally exposed middle and upper classes. However, the perceptions of volatility and insecurity loom large, particularly for foreign investors or investors without strong local ties who find it difficult to establish a local presence or conduct due diligence, and hence, refrain from investing despite recognizing the potential in the country.

The impact investing space in Pakistan is diverse, with a range of different actors.

Figure 8 provides an overview of the landscape of actors, including both impact investors and investors in related activities but without an explicit impact intention or commitment to measure impact.

FIGURE 8: OVERVIEW OF IMPACT INVESTOR AND RELATED INVESTOR TYPES IN PAKISTAN

TYPE OF INVESTOR	ESTIMATED NUMBER	DETAILS OF INVESTORS IN PAKISTAN
Fund managers	11 (7 impact investors)	Six international/regional funds and five Pakistan-specific funds
DFIs	11 (11 impact investors)	Making both direct and indirect investments, although a large proportion of capital is invested directly
HNWIs/Family offices	Several	There are many local foundations active in Pakistan as a result of a strong philanthropic culture
Diversified financial institutions/banks	More than 30 commercial banks	Little SME lending by banks, which are averse to risks caused by poor economic conditions and an increase in the number of non-performing loans

Within the fund manager landscape, we see a mix of both local and international players. Domestic investors are generally more commercially oriented but are increasingly adopting the impact intention. International funds are largely investing from offices outside Pakistan; only a few of them have a local presence. Additionally, four new Pakistan-specific funds are launching soon, of which three are by fund managers who have current investments in Pakistan. Further, regional funds are keen on exposure to the country.

Development finance institutions (DFIs) play a prominent role in Pakistan and have deployed most of the capital to date. This dominance of the impact investing landscape in Pakistan by DFIs is in large part due, as in other countries, to their greater ability to operate in riskier markets. As public entities, DFIs can work with the Pakistani government on policy-related issues to help shape and improve the investment climate, even while investing in the market itself.

There is a substantial presence of local high net-worth individuals (HNWIs), family offices, and foundations in Pakistan, but not many are actively engaged in impact investing; rather, their intent is either purely philanthropic or commercial. These players mainly provide grant capital to large charities and support social service provisions although some capital is channeled as grants to entrepreneurs. In addition, large business conglomerates have increasingly established family offices conducting investment activities alongside their philanthropic activities, which provide low- to no-return investments directly to enterprises at varying stages of growth. While there is still some aversion to investment in funds, as fund management in Pakistan builds a track record, these family offices may provide a large domestic pool of capital. With their investments, family offices tend to be commercially oriented, investing without an explicit impact intention, and with little public reporting or information available about their activities. As a result, these activities are either purely philanthropic or commercial investments—impact investing activities are yet to be seen by HNWIs, family offices, or foundations in Pakistan.

There are 18 active impact investors in Pakistan. This includes 11 development finance institutions and seven funds. In addition, there are commercial banks making SME loans, three funds, and an unknown number of angel investors investing in ways that are peripheral to impact investing. These angel investors are usually tied to incubators and accelerators and make small investments in early-stage enterprises.

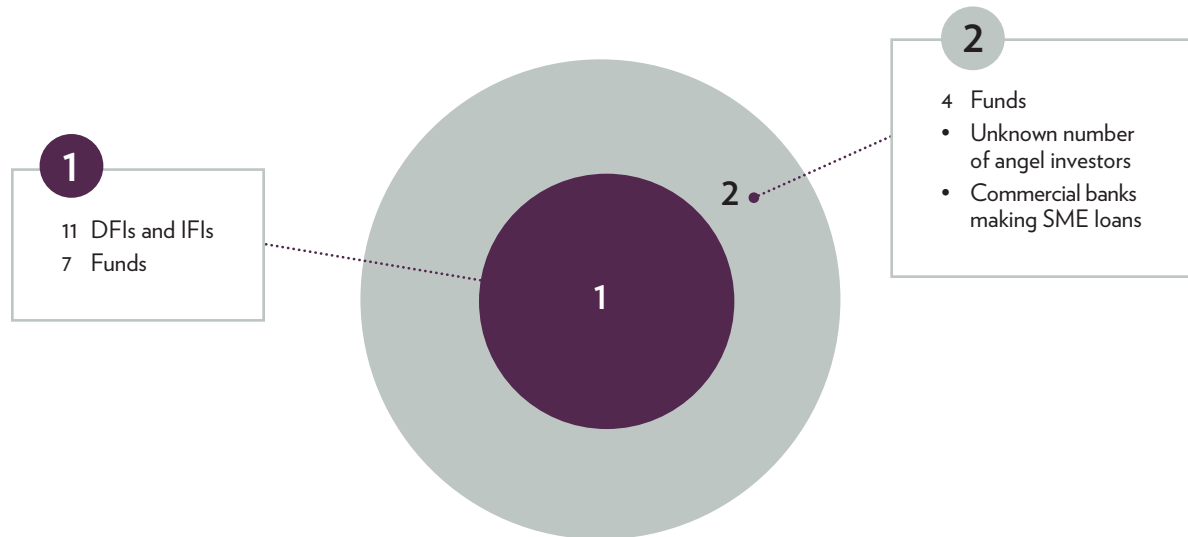
Funds operating in Pakistan fall across the two rings in our framework.⁷⁰

Approximately 36% of capital deployed by funds comes from impact investors (Ring 1) and the remaining 64% from impact-related investors (Ring 2). The key difference between these funds is the articulation of an explicit impact intention. There is a view from many fund managers that impact is achieved by default through their activities—whether this means increased access to capital where there was less before, or impact through investment in sectors like agriculture, which will affect farmer incomes, even without this being intentional *ex ante*. In terms of measurement, interestingly, even

⁷⁰ See “Defining key terms and concepts” in the introduction chapter of this report for an explanation of the framework used for categorizing investors using a two-ring framework, where the inner ring—Ring 1—represents the impact investing activity and the outer ring—Ring 2—represents the activity related to impact investing but lacking either an explicit impact intention or measurement.

the funds in Ring 2 have plans to introduce a metric-based measurement approach as they are intermediating or planning to intermediate DFI capital, which comes with a requirement to measure and report key impact metrics.

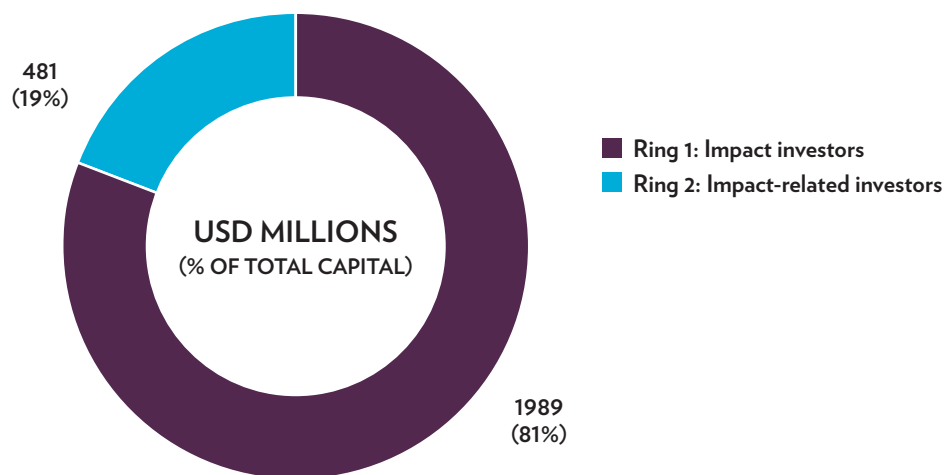
FIGURE 9: DIRECT IMPACT AND IMPACT-RELATED INVESTORS ACTIVE IN PAKISTAN



Sources: Stakeholder interviews, Dalberg analysis

Impact investors have deployed nearly USD 2 billion to date (see Figure 10). More than 50 deals have been directly made by DFIs with certain enterprises, and approximately 12 deals have been made by fund managers. Meanwhile, impact-related investors have deployed USD 481 million to date.

FIGURE 10: TOTAL CAPITAL DEPLOYED BY RING (USD MILLIONS)

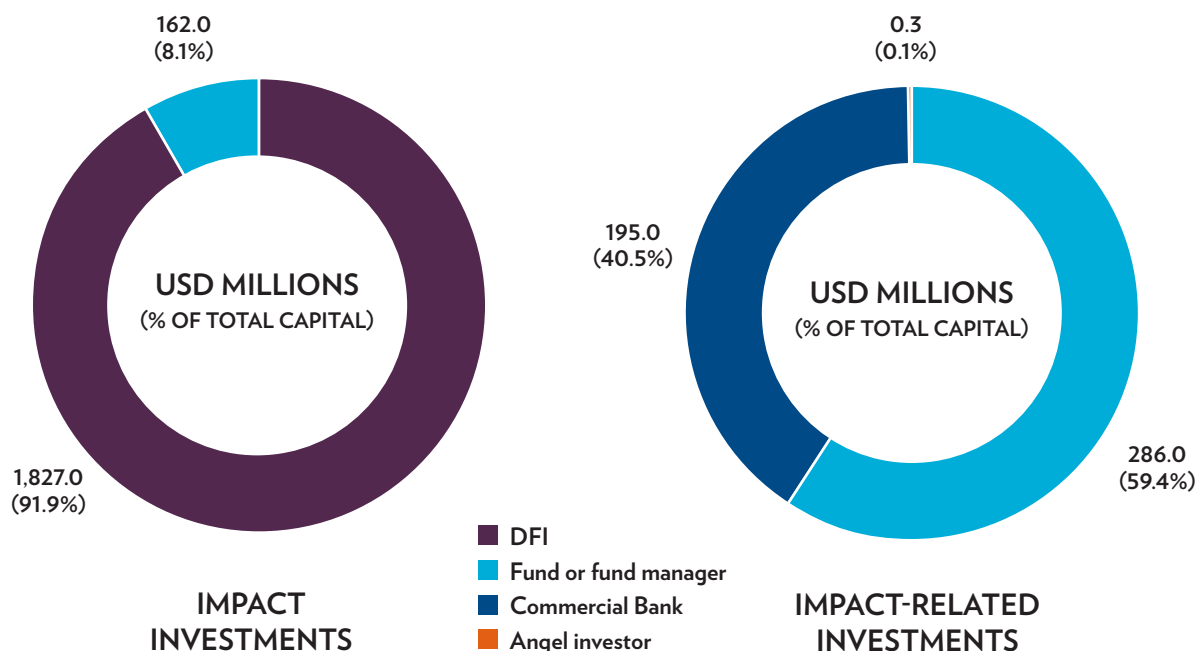


Sources: Stakeholder interviews; Investor websites; Dalberg analysis

INVESTOR MIX

Although we see a range of active investor types in Pakistan, DFIs represent the largest share of capital deployed and drive key trends. 92% of impact capital comes from DFIs, while the remaining 8% comes from fund managers. However, when it comes to impact-related investments, fund managers account for 59.4% of capital deployed and commercial banks (receiving earmarked DFI capital) for 40.5%. Moreover, a portion of the capital deployed by fund managers originates from DFIs as well, increasing their share of the total capital deployed.⁷¹

FIGURE 11: TOTAL CAPITAL DEPLOYED BY SOURCE (USD MILLIONS)



Sources: Stakeholder interviews; Investor websites; Dalberg analysis

Direct investments represent approximately 90% of all DFI capital deployed in Pakistan, due in large part to the lack of country-specific impact funds through which capital could be intermediated. In addition to the USD 1.8 billion that DFIs have invested directly into enterprises, they have also invested a minimum of USD 49 million in impact funds. DFI investments into commercial banks have been driven by an interest to increase access to capital for small or medium enterprises (SMEs), a segment that is difficult for DFIs to target directly due to their requirement of a large deal size (average deal size for DFIs in Pakistan is USD 27 million). However, there are three new impact funds being launched in the near future, which will be strongly backed by DFIs.

⁷¹ Given the lack of fund breakdown in terms of sources of capital, and funds investing in more than one country, it is not possible to calculate the proportion of capital deployed by fund managers that originates from DFIs.

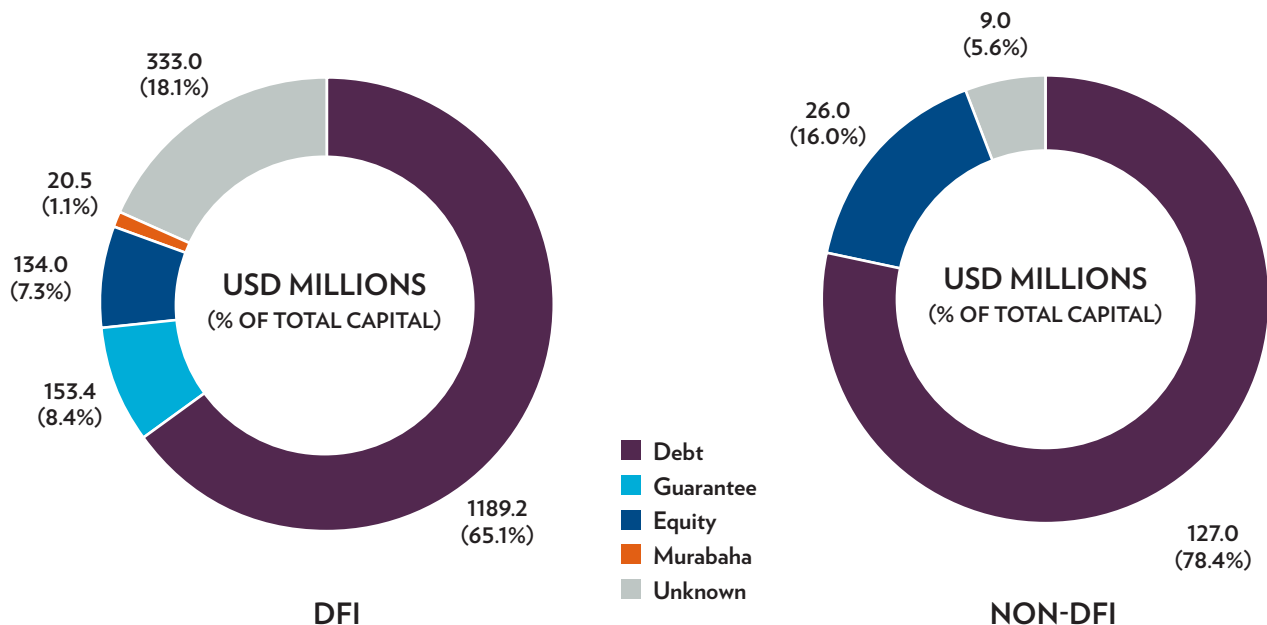
Key trends of impact investing in Pakistan

The following section examines trends among impact investors, the core ring of investors under study. The figures quoted in this section refer only to investors in Ring 1, who have collectively deployed approximately USD 1.99 billion. The activities of impact-related investors will be discussed in the section “Beyond the impact investing market.”

INSTRUMENT

As illustrated in Figure 12, most impact capital has been deployed in Pakistan through debt. This is largely driven by DFI investors, who tend to prefer debt investments, due to a low risk appetite, lower level of due diligence required as compared to making equity investments, and less active post-investment management. Non-DFI impact investors invest a greater percentage of capital in equity than DFIs (16% versus 7.3% for DFIs). The large debt percentage is driven by one investor who provides subsidized loans to microfinance institutions (MFIs).

FIGURE 12: IMPACT CAPITAL DEPLOYED BY INSTRUMENT



Sources: Stakeholder interviews; Investor websites; Dalberg analysis

Although investors have articulated an interest in using more quasi-equity instruments, thus far, there have been no related deals. This interest in quasi-equity arises from the difficulty (or perceived difficulty) of exiting pure equity investments. Since there have been no impact equity exits thus far, investors believe that structuring deals as quasi-equity creates the opportunity to exit through a payback-type mechanism. However, a lack of understanding of this form of investment—by both enterprises and regulators—as well as an aversion on behalf of regulators to introduce and approve new instruments, has slowed the uptake of quasi-equity.

There is some experimentation with other instruments (guarantees, social impact bonds, and Murabaha) in Pakistan. DFIs offer guarantees to banks to encourage more private sector SME lending, since banks have mainly preferred lending to the public sector where rates are high and defaults low. Murabaha, or zero-interest loans (described in Figure 13), have been used by Middle Eastern investors, who have developed the instrument in line with the principles of Islamic Finance.⁷² In a very nascent stage, there are investors exploring the possibility of raising a social impact bond for the education sector in Pakistan as well.

FIGURE 13: ALTERNATIVE INSTRUMENTS USED BY INVESTORS IN PAKISTAN, AND RATIONALE FOR THE INSTRUMENT

Instrument	Rationale
Guarantees	<ul style="list-style-type: none"> • Bank lending to SME sector is low, since commercial banks view the SME sector as very risky. Hence, to increase the amount of commercial debt SMEs can access, some IFIs/DFIs are providing guarantees to banks • Also provided to commercial banks by institutional investors to increase the funding available to the microfinance sector, as commercial banks tend to be risk averse with respect to this sector • Guarantees provide a multiplier effect in terms of impact, and reduce the amount of risk the investor has to bear
Social impact bonds	<ul style="list-style-type: none"> • There are a few investors who are looking at using social impact bonds in Pakistan—in the education sector (e.g., a London-based merchant bank created a sample pilot for a DIB for low-cost private schools but has yet to implement/fund this DIB)
Murabaha	<ul style="list-style-type: none"> • Murabaha is the sale of a good at cost plus an agreed profit mark-up; occurs when an intermediary purchases from the bank at the 'purchase price' and sells to the customer at the 'sale price' • It is different to short-term debt because it is the sale of a tangible asset on a fixed profit margin rather than money advanced • Murabaha is being used by a Middle Eastern investor in Pakistan, where there is a better understanding of Islamic banking principles

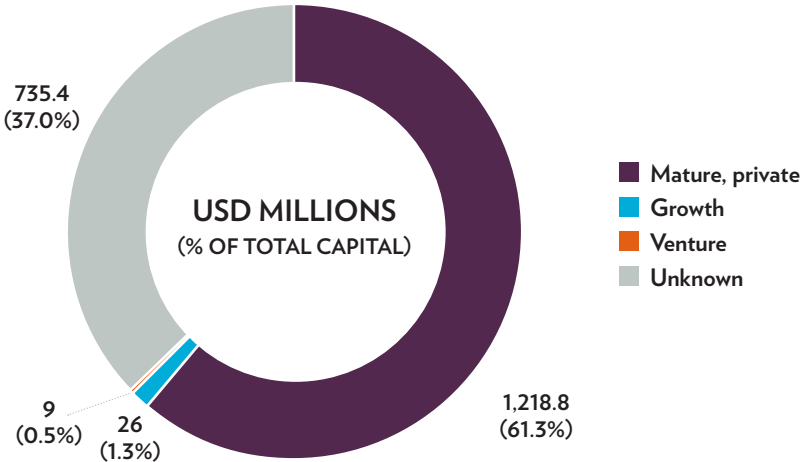
Sources: Stakeholder interviews; Dalberg analysis

72 Institutions that practice Islamic banking principles mobilize financial resources and invest them in an attempt to achieve predetermined acceptable social and financial objectives, wherein both mobilization and investment of funds should be conducted in accordance with the principles of Islamic Shari'a.

GROWTH STAGE AND DEAL SIZE

Mature companies have absorbed most of the overall impact capital deployed to date. This trend is again driven by DFIs who are the leading investors in this field and have a preference for larger deal sizes (given the transaction cost of investments), and have invested approximately USD 1.2 billion in mature organizations. Only companies at this stage can absorb these large amounts of capital. Additionally, mature companies have an established operating history, are legally registered, and keep accurate financial records—factors that lower the risk for investors and ease the monitoring process. Meanwhile, investments from fund managers have been exclusively in venture and growth stage organizations (see Figure 14). Unfortunately, for non-DFI investors, information is unknown for a large percentage of investments by stage of business.⁷³

FIGURE 14: IMPACT CAPITAL DEPLOYED BY GROWTH STAGE (DFI AND NON-DFI)



Sources: Stakeholder interviews; Investor websites; Dalberg analysis

As in most markets, seed and venture stage enterprises find it difficult to access impact capital as these earlier stages are relatively risky and require a more active engagement by investors both pre- and post-investment. However, in Pakistan, there is a deep-rooted and widespread philanthropic culture that has resulted in a large number of foundations, charities, and other institutions that channel start-up grant capital to entrepreneurs. HNWIs, often themselves successful entrepreneurs, also serve as a source of grant capital. This relative ease of access to philanthropic

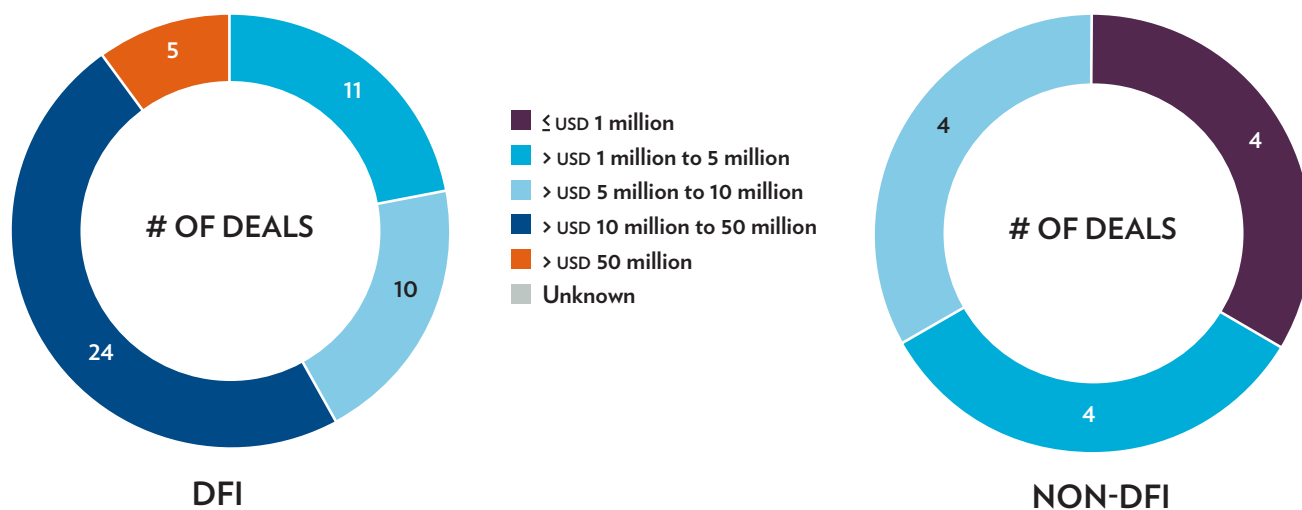
⁷³ A large percentage of invested funds are unknown with respect to the maturity of the enterprise as the portfolio breakdown of significant investors such as the ADB and the Pakistan Poverty Alleviation Fund is unknown.

capital, while a positive marker for entrepreneurs, is also a deterrent for early or venture stage investors who may perceive a lesser need and opportunity to invest in early-stage ventures.

Within DFI investments in Pakistan, we see a spread of deals across a range of deal sizes. While most of the DFI deals have been more than USD 10 million, there exists an active market in the USD 1–10 million range. No DFI deals have been below USD 1 million.

Within impact investment funds, we see a range of deal sizes below USD 10 million, including a handful below USD 1 million. Recognizing the gap and need for small to mid-sized deals, particularly for SMEs, the new funds being launched are likely to target this segment, focusing on deals in the USD 3–15 million range. Interestingly, more commercially focused funds are willing to make smaller deals (typically around USD 3 million) if they are in high-impact sectors such as education. However, even this amount of capital is probably more than what many enterprises in these sectors can absorb. The reason for the relatively high minimum ticket sizes is the fact that the cost of due diligence in Pakistan is high—there are no intermediaries, it is dangerous, and the field component to establish and follow-up on investments and deals is essential.

FIGURE 15: NUMBER OF IMPACT INVESTMENT DEALS BY SIZE

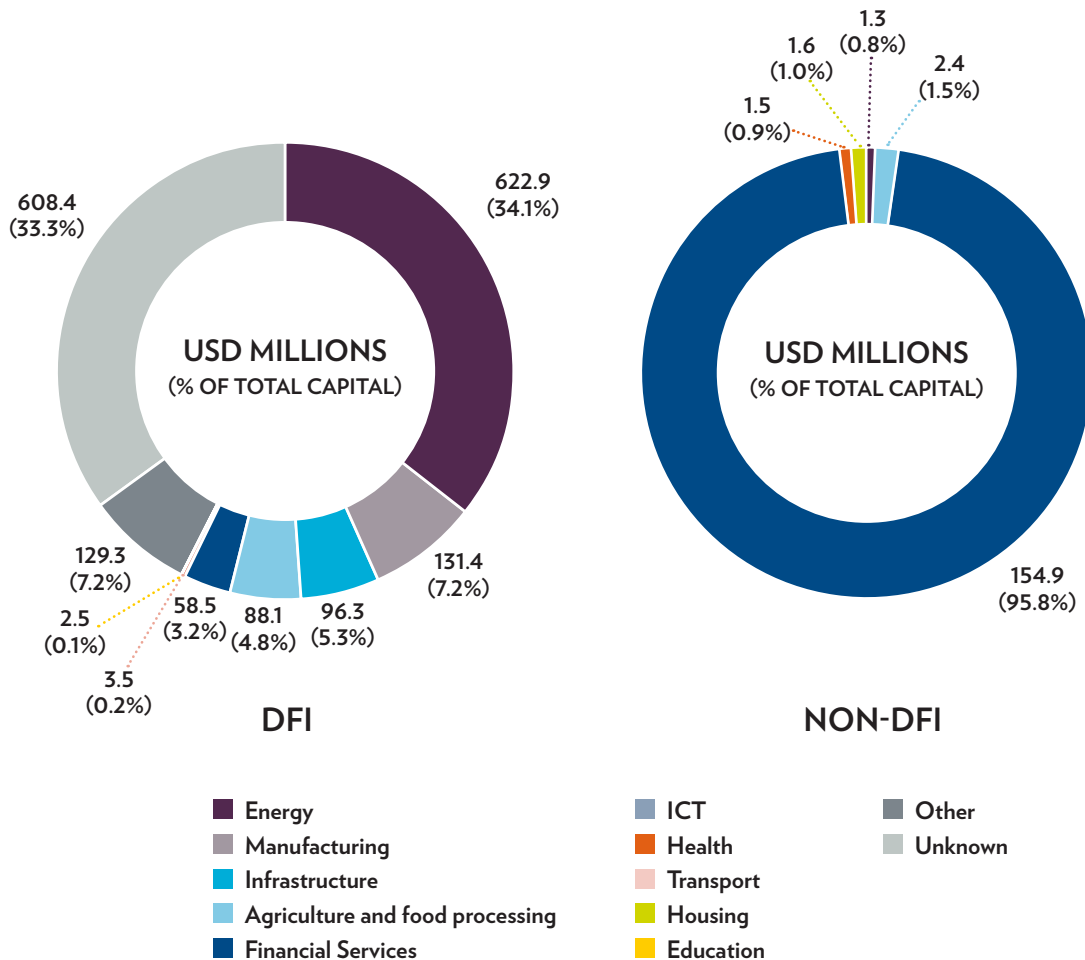


Sources: Stakeholder interviews; Investor websites; Dalberg analysis

SECTOR

Of the known deployed capital, the energy sector has received more impact capital from DFIs than any other sector. Capital from non-DFI investors has gone primarily into financial services, with small amounts in energy, housing, agriculture, and health. Given Pakistan’s acute energy crisis, many DFIs have invested heavily in renewable energy plants and other infrastructure projects that are key to the country’s growth and development. These projects also enable large ticket size investments that align with DFI mandates.

FIGURE 16: PERCENTAGE OF TOTAL IMPACT CAPITAL DEPLOYED BY SECTOR



Sources: Stakeholder interviews; Investor websites; Dalberg analysis. Notes: Unknown refers to investments for which investee details were not made public or shared with the research team.

The microfinance sector has received large amounts of impact capital—predominately from one domestic fund (with source capital from international financial institutions (IFIs)/DFIs). The microfinance sector in Pakistan is particularly interesting for impact investors from both a returns and an impact perspective. Given the large unbanked population and the need for small enterprise loans, the opportunity to invest in microfinance institutions is significant. These institutions are also “known entities” and easier to identify, and the sector is very well regulated, making investments attractive and lowering the risk profile. However, the leading

microfinance fund (with a current portfolio of USD 127 million), which has been instrumental to the growth of the industry, can also lend at subsidized rates. This is somewhat of a deterrent for investors as, while attractive to organizations seeking capital, this access to subsidized capital limits opportunities for investors to engage in the sector with market rate expectations. Some impact investors have taken equity stakes in microfinance institutions, but debt is not a viable instrument if not provided at the same subsidized rates.

Larger funds are generally sector agnostic, with a preference for consumer-focused sectors. The large domestic consumer base is attractive to investors as they see a high growth potential in consumer-facing sectors such as fast moving consumer goods (FMCG), healthcare, and agriculture. Thus far, we have seen fairly low levels of impact investing activity in service sectors such as healthcare and education, in large part because service provision and financing in these sectors have been heavily dominated by the charitable and philanthropic segments. Subsidized financing available from HNWLs, foundations, and family offices limits the demand for market-rate capital. From the perspective of business model/service provision, most non-public provision is through NGOs, although private provision exists for the very high-income segments. A proliferation of low-cost private schools provides some cause for optimism about opportunities for impact investment in the education sector, but currently few of these schools are high quality or operating at scale.

Return expectations and exit possibilities

Equity investors in Pakistan have a wide range of return expectations, but typically expect a return higher than most other asset classes as well as their own cost of capital. Commercial bank interest rates in Pakistan are typically pegged at 15%–20%, and other asset classes provide returns up to about 7%–13% (fixed deposits, government securities, etc.). Capital market gains have been much higher, with the Karachi Stock Exchange offering returns as high as 40% in 2013, much better than the world average.⁷⁴

Equity investors expect returns that are adjusted for a higher level of risk. For fund managers, this ranges from 20%–40%. Part of the reason for this variation in expectation is the type of deal used as a benchmark. In the absence of equity exits by impact investors, fund managers are setting expectations using a broader set. In the past, there have been equity exits that returned close to 40% internal rate of return (IRR) or even 10x multiples on capital. However, these were rare cases and usually a result of particular circumstances. For example, in concessionary sectors such as ports and other infrastructure where there is government backing, very high returns are possible. In independent power producer projects, for instance, the government ensures at least a 20% return. In other sectors where markets are not perfectly competitive and pricing is distorted, high returns are possible, but these are potentially risky investments to make. Pragmatic fund managers looking at the current market suggest that the 30%–40% returns expectations are overly ambitious; however,

⁷⁴ *Economist*, How did Karachi get a world beating stock exchange?, 2013.

20%–25% is more achievable, with up to 28% being a very good result. That said, as with other countries in our study, these are largely hypothetical considerations at this stage and the results will only be seen over the next few years as equity investors start to exit.

Equity investors expect that trade sales will be the most likely exit mechanism given the prevalence of large business conglomerates that traditionally acquire and grow smaller businesses. Some experts have also hypothesized that there is an opportunity to leverage the preference of local family offices for direct equity investments to create secondary sale exits by selling stakes directly to family offices that are otherwise averse to deploying capital through funds. Overall, however, there is still little clarity on what is possible and what the best mechanisms will be since there is little track record.

Impact measurement

With respect to impact measurement, the options for investors are to either adopt an existing standardized framework or to create a custom framework. We see DFIs largely using frameworks developed in-house; these frameworks are based on global standardized metrics, such as Impact Reporting and Investment Standards⁷⁵ (IRIS) or Environmental, Social, and Governance (ESG) factors, and are used across their portfolios in all countries. ESG metrics measure the environmental, social, and governance performance of enterprises, and metrics for measurement include the number of employees (socio-economic impact) and governance ratings. IRIS is a catalogue of recognized performance metrics, from which investors can choose those that best match their impact strategies and their investees' business models.

Fund managers in Pakistan are largely taking a cue from the DFIs that they work with; where they are required to adopt standardized metrics, some do, and in other cases, they take a more customized approach based on the metrics relevant for their sectors of investment.

⁷⁵ IRIS is a set of standardized metrics for impact measurement managed by the Global Impact Investment Network (iris.thegiin.org).

FIGURE 17: INVESTOR IMPACT MEASUREMENT

	METRIC-BASED IMPACT MEASUREMENT	ANECDOTAL IMPACT ASSESSMENT
Rationale for this approach	<ul style="list-style-type: none"> • If DFI/IFIs acting as LP for fund, metric-based reporting is required • International impact investors have a defined set of metrics that can be applied for their investments in Pakistan without having to develop a new set of metrics 	<ul style="list-style-type: none"> • For more commercially oriented investors, metric-based impact measurement is difficult and is secondary to launching and managing a fund, so anecdotal assessment used as default • Belief that impact is inherent because of the sectors they work in (e.g. agriculture and education) and therefore measurement is not required
Key indicators measured	<ul style="list-style-type: none"> • Social impact is primarily measured by economic metrics (e.g., number of jobs created) with assumption that economic impact will have social benefits • Some investors are using IRIS metrics or ESG metrics 	<ul style="list-style-type: none"> • Stories of lives touched and entrepreneurs supported by investment
Rationale for indicator selection/preference	<ul style="list-style-type: none"> • Selection of indicators is case specific (differs by sector and type of enterprise) • Indirect impact (e.g. quality of life) is difficult to measure, and thus, there exists a preference for economic metrics • Preference for ESG compliance driven by widespread recognition that ESG compliance satisfies basic impact criteria and mitigates risk of non-compliance for investor and investee 	<ul style="list-style-type: none"> • Desire to share qualitative benefits of investment

Sources: Dalberg analysis; Stakeholder interviews

Beyond the impact investing sector

Outside of the “core” impact investors, there exists a peripheral group of impact-related investors who have deployed USD 481 million to date. As discussed above, these investments come from commercial banks who are backed by DFIs (USD 195 million), funds or fund managers (USD 286 million), and a small group of known angel investors (a minimum of USD 265,000).

Approximately 80% of capital invested by these impact-related investors is through equity deals and 82% of the investments have been made in mature companies. While sector breakdown for a significant portion of this capital is unknown (USD 271 million), we see that a large percentage of the remaining known capital (93% of USD 210 million) has been invested in the financial services sector, outside of microfinance. Angel investors (usually tied to incubators and accelerators) prefer information and communication technology (ICT)-related enterprises as they see more exit potential with these companies, primarily through acquisition by overseas companies or investors (e.g., those from Silicon Valley).

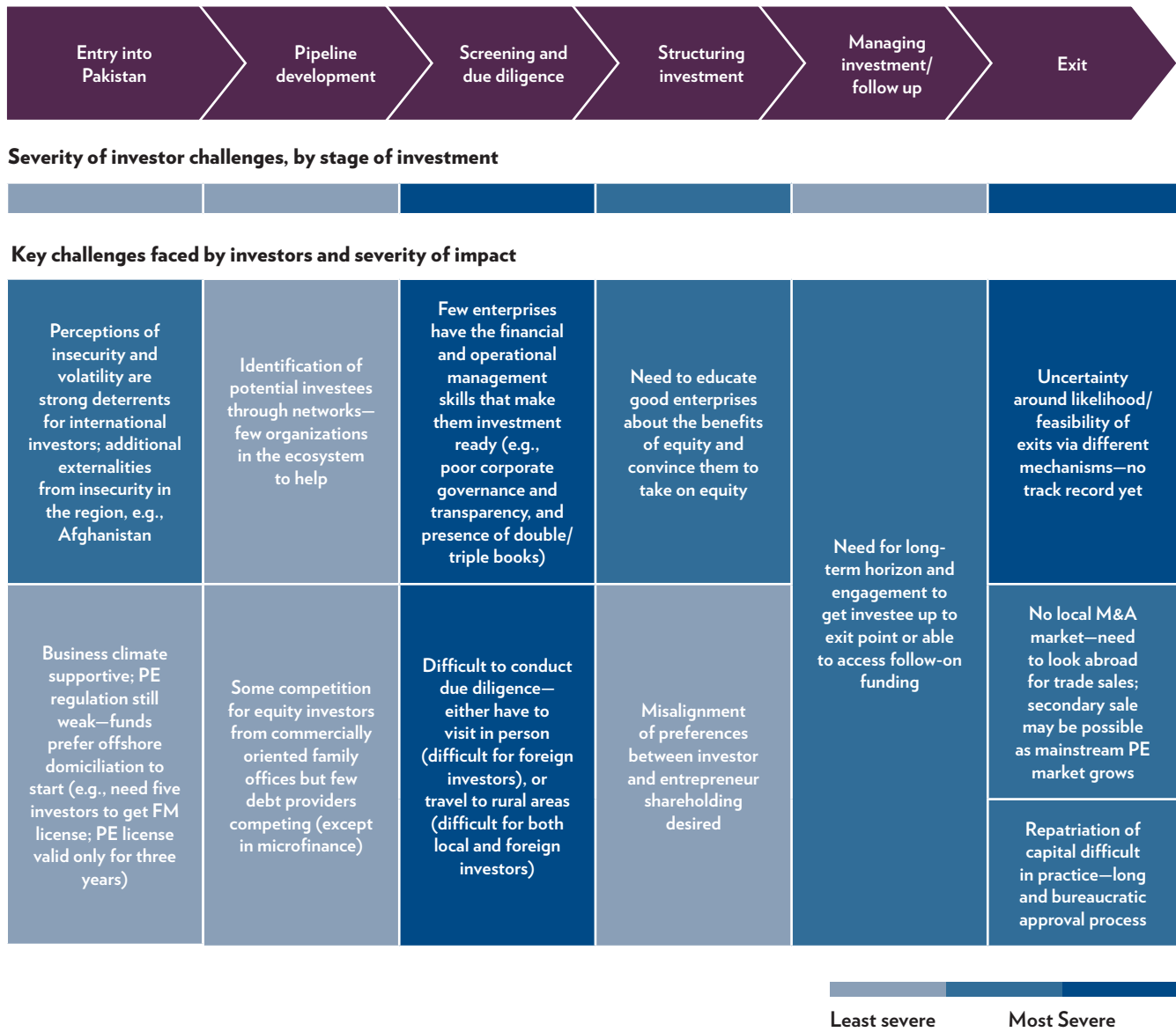
Challenges facing impact investors in Pakistan

While investors see enormous potential in Pakistan, a large number still perceive too much risk related to the security threats and political instability to make Pakistan a viable, investible market at this stage. Importantly, much of this perception is held by investors abroad and understood through the lens of the international media. However, investors already active in Pakistan, or those with personal links to the country, do not consider these severe deterrents, although of course, caution is important. The key implication of the current security situation for local investors or those with experience in investing in Pakistan is the limitation on geographies in which investment (and even broader business) activity is possible. The regions of Punjab and Sindh have historically had the most vibrant entrepreneurial environments, but recently, due to security concerns, much of the rest of the country is inaccessible, and hence, investors concentrate heavily in these two regions.

For investors who can overcome these perceptions of risk, Pakistan has a relatively welcoming investment environment. Getting started in the country in terms of licenses and approvals to start businesses is relatively straightforward and not too time intensive. The few challenges that are experienced at this stage are related to private equity regulation in particular. As an industry that is relatively less well understood, investors are having to work with regulators to develop and reform existing policies (e.g., private equity licenses are only valid for three years, which is too short for the life of most funds).

Beyond this initial entry stage, the key challenges for investors are in the screening and due diligence stage and then at exit, which by nature affect equity investors more than debt investors.

FIGURE 18: CHALLENGES AND SEVERITY OF CHALLENGES FACED BY INVESTORS, BY INVESTMENT STAGE



Sources: Stakeholder interviews; Dalberg analysis

The identification of investment targets in Pakistan is less challenging than in the other countries considered in this study—with the exception of India—due to the strongly entrepreneurial culture of Pakistan. Most investors report a significant amount of opportunity in the country. Networks in Pakistan are extremely strong, and pipeline companies are mainly identified through these personal networks. This highlights the importance of having a ground presence and is a large part of why international investors find it challenging to invest in Pakistan from abroad without going in as part of a group. As a stronger support ecosystem develops, players who can provide matching services for relatively small-ticket and angel investors are emerging, but this is not true for large-ticket funds or DFIs.

The key constraint to investing in Pakistan is getting through the middle stages of screening and due diligence to convert opportunities into investable deals.

Given the nature of an equity relationship, this is a particularly severe challenge for equity investors who need to have a much clearer picture of the health and the potential of the business as well as an understanding of the entrepreneurs themselves. Few enterprises have the financial and operational systems and structures in place that make them investment ready. Many enterprises lack transparency and proper corporate governance structures, maintain double or triple sets of accounts, and lack appropriate registrations. There is also concern about the political connections and business practices of business owners in a climate where corruption is rampant. These concerns are held equally by equity and debt investors, particularly given the potential reputational damage to investors who are associated with malpractice. Therefore, investors have to spend several months working with companies to educate them on the requirements for investment (particularly for equity) and building the appropriate systems and structures before a deal can actually be closed.

Conducting formal due diligence is also a challenge for investors, particularly equity investors, for whom the process involves a physical visit to enterprise operations. For foreign investors, this means traveling to Pakistan, which many are wary of given the political and security concerns. Even for local investors, traveling to rural areas to assess value chains is rather tricky.

When it comes to structuring a deal, investors in Pakistan are fairly experienced; however, training may be required to improve the local enterprises' understanding of equity. Family businesses in particular are extremely wary of opening up to external investors and are nervous about the equity timeline, which they perceive to be quite short. Therefore, impact investors report having to spend time convincing business owners of the benefits of equity. Investors also report facing competition for deals from domestic family offices that are (a) more flexible in the terms that they offer, (b) more lenient with respect to the enterprise's corporate governance structure, and (c) more willing to take longer equity time horizons as they do not have limited partner (LP) capital to return.




In addition to the timeline, transparency, and understanding of equity instruments, the other challenge reported by some investors and entrepreneurs is a misalignment of preferences around the stake that investors want and the stake that entrepreneurs are willing to give up. Investors express a range of preferences from a controlling stake to minority stakes, but this is often not aligned with the entrepreneurs' preferences or perceptions of value. Hence, there is a need for education and understanding on both sides, including understanding of when investors should take a controlling stake (e.g., distressed buyout) versus when they should not (e.g., seed or venture stage investments).



As discussed earlier, the lack of a track record in exits makes investors uncertain of the potential exit mechanisms for their equity investments. While there is some expectation that trade sales will be possible domestically, the local mergers and acquisitions market has been fairly slow. Therefore, investors are considering foreign sales either to senior funds or larger enterprises for exits. Moreover, exit horizons in Pakistan are expected to be long—while the traditional five-year horizon is still a target, most investors take a pragmatic view and expect a slightly longer tenure, some

as long as 10 years.

While the entrepreneurial activity and business management skills of Pakistani entrepreneurs are perceived to be quite strong, there is a need for ongoing support and development both pre- and post-investment. In response to this need, a few investors have taken an increasingly active role in providing technical and managerial support as well as strategic guidance, but by and large, this function is left to the actors in the broader ecosystem. In fact, some investors active in support services have their own advisory divisions (e.g., the International Finance Corporation (IFC)), and others contract with specialized providers. Incubators and accelerators either provide assistance along with funding or arrange for funding from their angel networks. Furthermore, several equity investors may take a Board seat to provide strategic inputs during operations.

FIGURE 19: NON-FINANCIAL SUPPORT PROVIDED BY INVESTORS TO ENTERPRISES

Key Enterprise-Side Gaps Identified By Investors	Severity	Organizations Offering Non-financial Support	Services Offered
Lack of business management skills		<ul style="list-style-type: none"> • IFC 	<ul style="list-style-type: none"> • Advisory team to provide technical assistance to clients • Web-based SME toolkit
Poor operational/ financial management skills		<ul style="list-style-type: none"> • USAID • DFID 	<ul style="list-style-type: none"> • Funding allocation for technical assistance to SMEs
Lack of access to information/networks		<ul style="list-style-type: none"> • i2i • Plan 9 • Seed Incubation Center 	<ul style="list-style-type: none"> • Integration into entrepreneur and funding networks through the incubator/ accelerator model

 Least severe
 Most severe

Sources: Stakeholder interviews; Investor websites; Dalberg analysis

Looking forward

The impact investing industry is evolving rapidly in Pakistan with current investors committing significant additional capital and new funds being raised for deployment. Despite the security and stability concerns, investors are optimistic (driven by domestic investors and fund managers who can support international investors who otherwise would not likely be able to engage in the Pakistani market). To date, an additional USD 103 million has been committed but not yet deployed by existing investors, and four fund managers have raised USD 215 million for Pakistan-specific funds (three of which are seeded by USAID’s Pakistan Private Investment Initiative).

Furthermore, several regional funds have raised capital for deployment, with Pakistan being a focus country. Even with the increased competition due to the new funds entering the market, investors are confident that there are more than enough investable opportunities and that the ecosystem is now becoming sufficiently robust and vibrant to support a rapid scale-up of the industry.

NEEDS AND OPPORTUNITIES: THE DEMAND SIDE

The majority of impact capital in Pakistan is directed to large-scale mature infrastructure enterprises, primarily in the energy sector. As highlighted in the section titled “Investing in Pakistan: The supply side,” this preference for infrastructure development and large companies is driven in large part by DFI investment mandates and is also reflected in the preference for financial services and telecommunications companies, as described above. Moreover, while other sectors such as education and healthcare are considered interesting, they have yet to receive significant investments.

Given that Pakistan has one of the most vibrant impact enterprise⁷⁶ landscapes in the region, we do see a reasonable share of impact capital directed into impact enterprises—primarily into microfinance institutions. To date, according to investors interviewed in Pakistan, the SME sector has been relatively unattractive, although some impact capital has been channeled through commercial banks by DFIs with the intention to increase SME access to capital. However, this is likely to change over the next few years as four new SME-focused funds that are currently raising capital begin to invest.

Overview of impact enterprise ecosystem in Pakistan

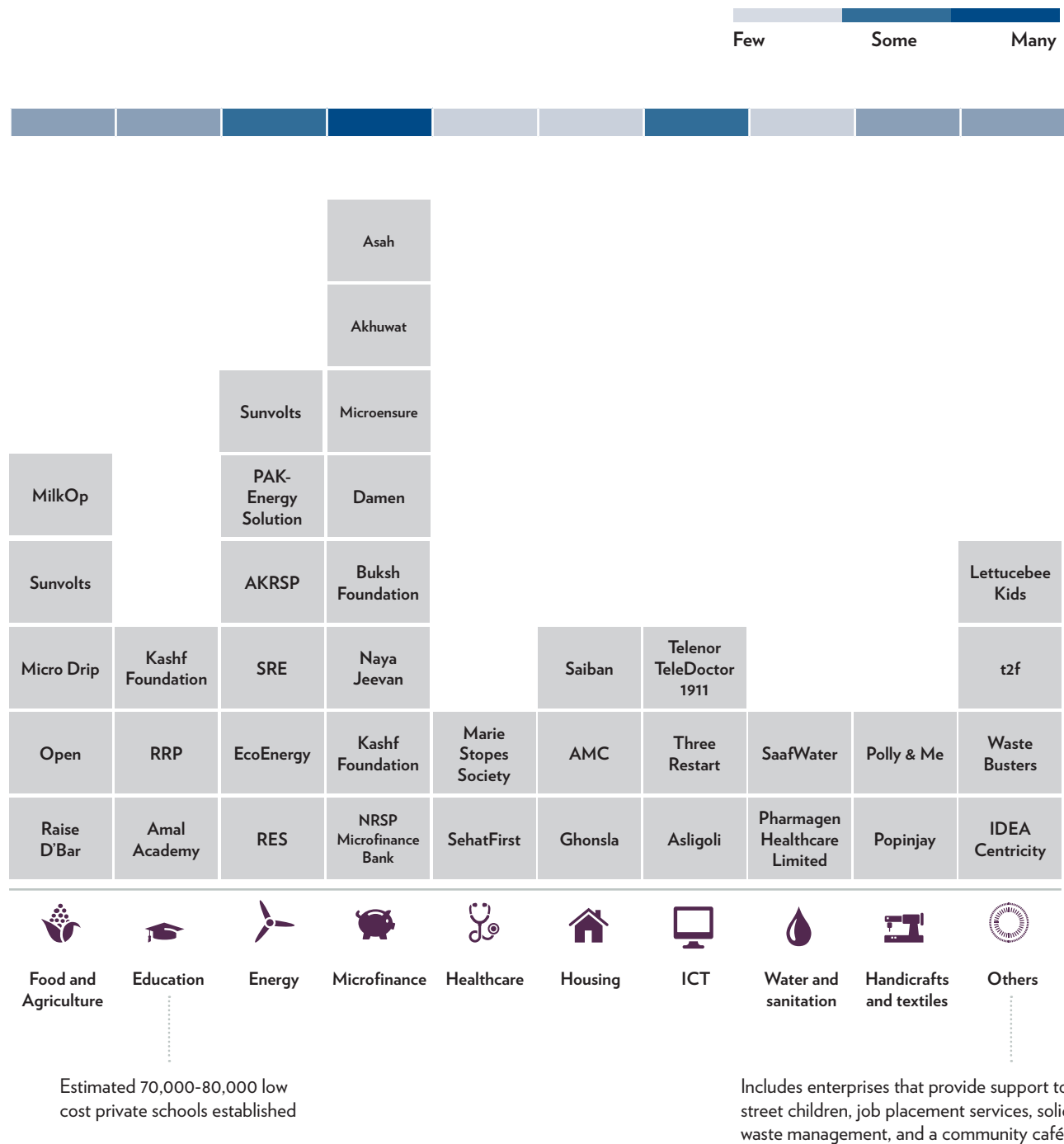
SECTOR TRENDS

Looking specifically at the impact enterprise sector, we find that the landscape in Pakistan is evolving rapidly with an increasing number of enterprises defining themselves as impact-oriented and with entrepreneurs establishing businesses across a wide range of sectors (see Figure 20). Currently, the most common type of impact enterprises, as in most of the countries considered in this study, is microfinance institutions. There is increasing activity in broader financial services as well as in the

⁷⁶ *Impact enterprises for the purposes of this report are defined as those that have articulated a core objective to generate a positive social or environmental impact (i.e., as a part of their operating model rather than an ancillary activity as with CSR programs) and seek to grow to financial viability and sustainability.*

sectors of energy, food and agriculture, and education. Moreover, consumer-facing products, such as handicrafts and textiles, are increasing and have huge potential given Pakistan's sizeable and growing middle class.

FIGURE 20: RELATIVE NUMBER OF IMPACT ENTERPRISES BY SECTOR, WITH EXAMPLES



Sources: Stakeholder interviews; Investor websites; Dalberg analysis

Microfinance is a particularly attractive sector for investors in part due to factors that are standard across all countries—they are better known and easier to identify, and have measurable impact in terms of economic and gender empowerment as well as rural reach—and in part due to the strong and attractive regulatory environment in Pakistan.⁷⁷ Pakistan ranks third of 55 countries for

favorable regulatory and operating conditions for microfinance. It is one of the few countries in the world that has a separate legal and regulatory framework for microfinance banks and is regarded as one of the most enabling environments for microfinance both regionally and globally.⁷⁸ In addition, the State Bank of Pakistan (Pakistan's central bank) mandates that all microfinance banks educate their clients on the terms and conditions of their products, and has institutionalized a procedure for managing and addressing client complaints.⁷⁹ Moreover, as of 2013, Pakistan had more than 50,000 fixed microfinance branches, more than 200 mobile branches, and a total gross microfinance loan portfolio of around USD 97 million.⁸⁰ In comparison, the number of microfinance branches in Bangladesh in 2009 (latest data year available) was less than 18,000.⁸¹

The microfinance sector has seen particularly strong growth in recent years and has been identified as a sector with a continued strong growth potential.

Opportunities for growth are understood to be in terms of both scale (e.g., reaching new unbanked clients), and innovation and development of new products (e.g., leveraging branchless and mobile technologies). The sector is undergoing significant transformation with nonprofits increasingly restructuring to become microfinance institutions to increase their sustainability and formalize under the regulatory umbrella, and microfinance institutions looking to restructure into microfinance banks, which would enable deposit taking and growth. Both sets of transformations create significant opportunities for impact investors.

The education sector is also seen as a sector with enormous potential for impact enterprise models and as a destination for impact capital across the full value chain from pre-school to tertiary education and vocational training. For now, while there are many thousands of low-cost private schools,⁸² few are structured as impact enterprises, having been started out of a recognized opportunity to make a quick commercial return in a relatively unregulated industry. Given the lack of regulations, many of these schools are of low quality and not necessarily established with the long-term scale in mind. There is strong investor interest in exploring the opportunities to develop some higher-quality, larger-scale, sustainable and affordable private schools out of this landscape, but these efforts are in their nascent stages and will take time to develop.

77 *There is a separate legal and regulatory framework for microfinance banks (by the State Bank of Pakistan) under the MFI Ordinance 2011. The act provides a framework through which microfinance banks can be established or commercial banks can scale down.*

78 *The Economist Intelligence Unit, Global microscope on the microfinance business environment, 2013.*

79 *Op Cit. Economist Intelligence Unit (2013).*

80 *Pakistan Microfinance Network, Microwatch, 2013.*

81 *South Asia Micro-entrepreneurs Network (2009).*

82 *Some estimates suggest 70,000–80,000 across the country. Source: stakeholder interviews.*

A second potential area of opportunity is in the transforming NGO sector. NGOs have traditionally been heavily involved in the provision of educational services, but some are beginning to consider revenue generation to increase their sustainability and move away from the donor-dependent model. A few investors have already indicated that they are keen to invest in the education sector if the models are right, and even to make smaller deals with lower returns at the beginning in order to encourage growth.

Given Pakistan's severe energy deficit, and the implications of this deficit on growth and development, increasing access to energy is another growing focus for impact enterprises and a source of promise for investors. There are several impact enterprises (such as Eco Energy Finance) and foundations (e.g., Buksh Foundation) active in Pakistan, building business models around renewable energy access for rural populations. Social enterprises, nonprofit organizations, and foundations in the renewable energy sector are working independently, rather than partnering with the government, to provide access to energy for off-grid low-income populations. One of the most exciting features of this sector for investors and entrepreneurs alike is the availability of a wide range of business models tried and tested globally that can be replicated and adapted for the Pakistani context.

Given the importance of agriculture in the Pakistani economy, it is an attractive sector for impact-oriented entrepreneurs, although land ownership laws and working with rural communities can be challenging for business models. Agricultural enterprises have a range of models and missions, from organic farming for increased product value to better irrigation for improving crop yields. More entrepreneurs seem to focus at the moment on improving productivity and value chain strengthening rather than exploring niche markets and products (although this is likely to change). However, certain key challenges remain for entrepreneurs in the sector, including security considerations in rural areas and a lack of clarity around farm ownership laws and land titles.

Despite the low quality of public health provision in Pakistan, healthcare services is a difficult sector for impact entrepreneurs. First, capital costs to start such service facilities are high; therefore, entrepreneurs who are active in the sector target the high-end market segments where prices can cover costs. Second, service provision for lower income populations has been dominated by NGOs and charitable models (e.g., clinics sponsored by big conglomerates and corporate social responsibility (CSR) initiatives); therefore, it is difficult culturally to develop a fee-based model for these low-income populations. However, while direct service provision is difficult, a number of interesting models are emerging in ancillary or related services, such as microinsurance (e.g., Neya Jeevan and MicroEnsure), or for enhancing services and processes through ICT (e.g., Sehat First and TeleDoctor).

The housing sector has been a very challenging sector for entrepreneurs because of issues related to land ownership, a need for a large number of permits and approvals (which are costly and take significant time to obtain), and the large costs involved in projects. Issues related to land ownership include the fact that post-independence Pakistan has retained a feudal system of land tenure in which a small elite class owns a majority of land worked by tenant farmers and laborers. Between 20% and 40% of rural households are reported to be landless or have very

little land. Although the government has attempted to address the issue of land and tenure rights, these efforts have largely failed to take effect and change the system.⁸³ Therefore, this sector is not very attractive despite some interest from investors. In fact, an organization that had received impact investments for a low-cost housing project had to put its project on hold due to administrative and legal constraints.

ICT is likely to be a huge growth sector for entrepreneurs; however, these entrepreneurs are likely to be interested in commercial applications of new technologies rather than focus on social impact. The low start-up capital requirements and the greater perceived opportunities to access international investment and/or eventually sell the company to international buyers make this sector attractive for entrepreneurs. There are also several incubators and accelerators focused on technology-related enterprises emerging in Pakistan that will help launch start-ups in the ICT sector. Hence, having access to additional support is attractive.

Even though access to clean water is an issue, there are only a few enterprises (e.g., SaafWater and Pharmagen) in this sector due to the presence of NGOs and the difficulty of generating profits through low-margin business models. As a result, NGOs and foundations (e.g., The Orangi Project, Participatory Development Initiative, and Buksh Foundation) dominate the landscape in trying to serve the nearly 16 million people in Pakistan who do not have access to safe drinking water.

While not as dominant a sector as in the other countries in the region (such as Sri Lanka and Nepal), there are a few viable and visible enterprises working in the handicrafts sector, where they seek to increase employment of women⁸⁴ and create opportunities for income generation. In addition to some well-known enterprises (e.g., Popinjay), there are several rural microenterprises in this sector, financed initially through microcredit, but not necessarily with an intention to scale. Given the number of microenterprises, this could potentially be a relatively easy sector to promote for impact investors—the so-called “low-hanging fruit” that could be nurtured and supported to grow.

ORGANIZATIONAL TRENDS

Provision of services to the low-middle income population tends to be the primary theory of change (ToC) adopted by impact enterprises in Pakistan. Unlike other countries in the region where supply chain integration is a common ToC (except within the MFI space), the poor public provision of key services such as education and energy has resulted in a large opportunity for private enterprises and NGOs to fill these gaps (e.g., Neya Jeevan, Ecoenergy Finance, and Kashf Foundation). Similarly, provision of financial services is the impact thesis for microfinance enterprises. Although employment creation and generation is less common than models that engage BoP populations as consumers or customers, models that create employment and livelihoods are common particularly in the

⁸³ USAID, *Country Profile*, Property Rights & Resource Governance, 2011.

⁸⁴ *The labor force participation rate for women above the age of 15 years in 2012 was 16%, as compared to 80% for men.* World Development Indicators, The World Bank, modeled on ILO estimate, 2012.

agriculture and handicrafts sectors (e.g., Polly&me and IdeaCentricity).

In Pakistan, most of the impact enterprises have been established either by diaspora/Pakistani returnees or by locally well-educated entrepreneurs; very few enterprises have been started by foreigners. The diaspora/returnees are familiar with the concept of impact enterprises, are well-connected both overseas and within Pakistan, and have sufficient start-up capital from working abroad to start their own enterprises (e.g., Neya Jeevan and Popinjay). Locally, an entrepreneurial culture is being nurtured and further developed by schools such as Lahore University of Management Sciences (LUMS) that have launched business plan competitions and incubators to encourage entrepreneurs (e.g., Jasser Farms and IdeaCentricity). It is relatively uncommon to have foreigners start enterprises due to security concerns and the difficulty in getting the appropriate visas.

The potential for financial sustainability of impact business models is not yet clear. Most impact enterprises are very new, making it difficult to identify trends at this stage, and experiences to date are mixed with several enterprises having already been unsuccessfully closed, while others are on track to break even within the next 1–2 years. However, even as they grow to sustainability, many impact enterprises choose hybrid organizational structures, registering both for-profit and nonprofit entities. This structure enables access to both commercial capital through their for-profit structure and grants and philanthropic capital through their nonprofit structure.

Access to finance

The most significant constraint to impact enterprise growth in Pakistan is access to finance. However, the severity of this constraint varies by growth stage. As in other markets, the financing challenges enterprises face can be grouped into identification of capital, appropriateness of capital, and the actual access to this capital (see Figure 21). Moreover, impact capital that is available is not well aligned to the needs of impact enterprises in terms of deal size, risk appetite, and perceived alignment of values. Banks, for their part, have high collateral requirements that are difficult for SMEs to meet. Even some larger businesses, such as MFIs, struggle to access bank capital, as banks consider these businesses risky and unattractive, particularly if these banks can make similar returns by lending to the government.

FIGURE 21: SEVERITY OF ACCESS TO FINANCE CHALLENGES BY ENTERPRISE GROWTH STAGE



Severity of access to finance challenge, by stage of growth



Key challenges faced and severity of impact

Identifying sources of capital

Limited formal sources of capital for start ups; most seed funding from friends, family or philanthropy	Limited number of capital sources; banks don't lend easily to SMEs
Few domestic investors offering equity—when they do it's within their networks where they can easily vet	

Appropriateness of capital

Terms of bank loan not appropriate—requires operating history, existing cash flows and asset collateral	Lack of clarity on ease of IPO process—very little capital market activity—no investor has exited through IPO
Low levels of understanding of non-debt instruments and what type of capital is most appropriate for needs/stage	

Accessing capital

“Missing middle” deal size— very small amounts accessible through MFIs, informal channels; small needs for growth and scale up hard to access
Companies have weak financial records and corporate governance, increasing risk-aversion of investors
Collateral requirements are high, too high for new/young enterprises; entrepreneurs often take personal loans or use unregulated financial institutions, both of which have higher interest rates
Difficult to secure reliable third party valuation—difficult for foreign investors to invest






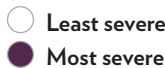
Sources: Stakeholder interviews; Dalberg analysis

Due to significant challenges in accessing capital for start-up enterprises, seed financing is predominantly accessed through informal sources (personal savings, friends, and family), as well as through grants or business plan competitions. In addition, numerous enterprises access capital through donations and grants from local philanthropists or from the Pakistani diaspora.

The availability and familiarity with sources of philanthropic capital create a strong preference for grant capital. Interestingly, relatively new entrepreneurs tend to be more comfortable with equity than managers of larger, more mature companies. These new entrepreneurs tend to be more familiar with international business models and structures, whereas established entrepreneurs who have built businesses with traditional family-based corporate governance structures are uncomfortable with external equity investments, strongly preferring bank debt, which is easier to access through established business networks.

FIGURE 22: PREFERENCES FOR CAPITAL BY SEED AND VENTURE STAGE ENTERPRISES

Instrument	Preference	Drivers of preference	Key barriers
Private Debt		<ul style="list-style-type: none"> Strong banking sector and awareness of how debt operates 	<ul style="list-style-type: none"> Excessive collateral requirements, short grace periods High interest rates, up to 20% Taking debt as start up is risky for both banks and entrepreneurs Cultural aversion to private debt because Islam discourages charging interest rates
Equity-like debt		<ul style="list-style-type: none"> A good way to reduce risks for investors while aligning their interests with those of enterprises 	<ul style="list-style-type: none"> Instrument is not well understood by both enterprises and investors
Public equity	<i>Not appropriate instrument for seed or venture stage companies</i>		
Private Equity		<ul style="list-style-type: none"> Less risky for early-stage enterprises Investors provide mentorship, strategy support, access to networks, etc., in addition to capital Concept well understood by new entrepreneurs (well educated, diaspora) who may also work with incubators/accelerators 	<ul style="list-style-type: none"> Few equity investors offering capital to venture stage companies



Sources: Stakeholder interviews; Dalberg analysis

FIGURE 23: PREFERENCES FOR CAPITAL BY GROWTH AND MATURE STAGE COMPANIES

Instrument	Preference	Drivers of preference	Key barriers
Private debt		<ul style="list-style-type: none"> • Strong awareness of how debt operates • Established businesses with collateral, profits, and strong networks find it easy to access commercial debt • Less involved diligence than for equity • Debt more appropriate for working capital 	<ul style="list-style-type: none"> • High collateral requirements and interest rates • Banks may still be unwilling to lend to some sectors like microfinance, which is deemed risky because they can make same returns on government lending
Equity-like debt		<ul style="list-style-type: none"> • Creates flexibility—can pay back equity as debt to exit for equity shareholders, or vice versa 	<ul style="list-style-type: none"> • Not a common instrument offered by investors • Little understanding among enterprises
Public equity		<ul style="list-style-type: none"> • Creates exit option for promoter 	<ul style="list-style-type: none"> • Family-owned businesses averse to increased transparency and external shareholding
Private equity		<ul style="list-style-type: none"> • Growing number of equity investors • Increasing recognition of value of equity investments—investors bring experience, networks, and additional support other than capital • Long-term relationship and financial horizon 	<ul style="list-style-type: none"> • Some enterprises reluctant to give up equity in their company—need education and convincing by investors (especially since mature companies tend to be family owned businesses) • Few private equity investors

Least severe
 Most severe

Sources: Stakeholder interviews; Dalberg analysis

Constraints to enterprise growth

While access to finance is a key constraint to enterprise growth in Pakistan (as it is in other markets), there are other business and operational challenges commonly faced by entrepreneurs. The three challenges, in particular, that are worth highlighting are as follows:

- **HR management, particularly hiring and retention:** Despite poor literacy among a majority of the population, Pakistan has a significant talent pool with a well-educated and internationally exposed cadre. However, many professionals migrate overseas or prefer to work locally in large corporations or multinational corporations (MNCs) rather than with smaller or impact-oriented enterprises.

- **Corporate governance and financial management:** Governance structures are usually weak and not designed for enterprise growth. Financial management skills are similarly often weak, including low capacity for financial record keeping and planning, which limits the development and growth of SMEs and start-ups in particular.
- **Marketing and market access capabilities:** This is generally a weak area for entrepreneurs in consumer-facing industries as the customer acquisition expertise of these entrepreneurs is low; this constrains growth in an environment where consumers are very distrusting until the product or service has been proved to be significantly credible. In particular, entrepreneurs have limited expertise in assessing markets and developing sales plans for growth.

ENABLING IMPACT INVESTING: THE ECOSYSTEM

Political instability, sectarian strife, the chronic energy crisis, and macroeconomic governance continue to be the key challenges to investment in Pakistan (see Figure 24). However, the perceptions of the severity of the security and regulatory environments as key constraints to investment differ between domestic and foreign investors. While foreign investors perceive sectarian strife and violence as a leading constraint to investment in Pakistan, domestic investors perceive it as a significant constraint but not the leading one, given that they have learned to adopt a “business as usual” approach within such a volatile environment. For domestic investors, challenges in the regulatory environment are seen as more critical.

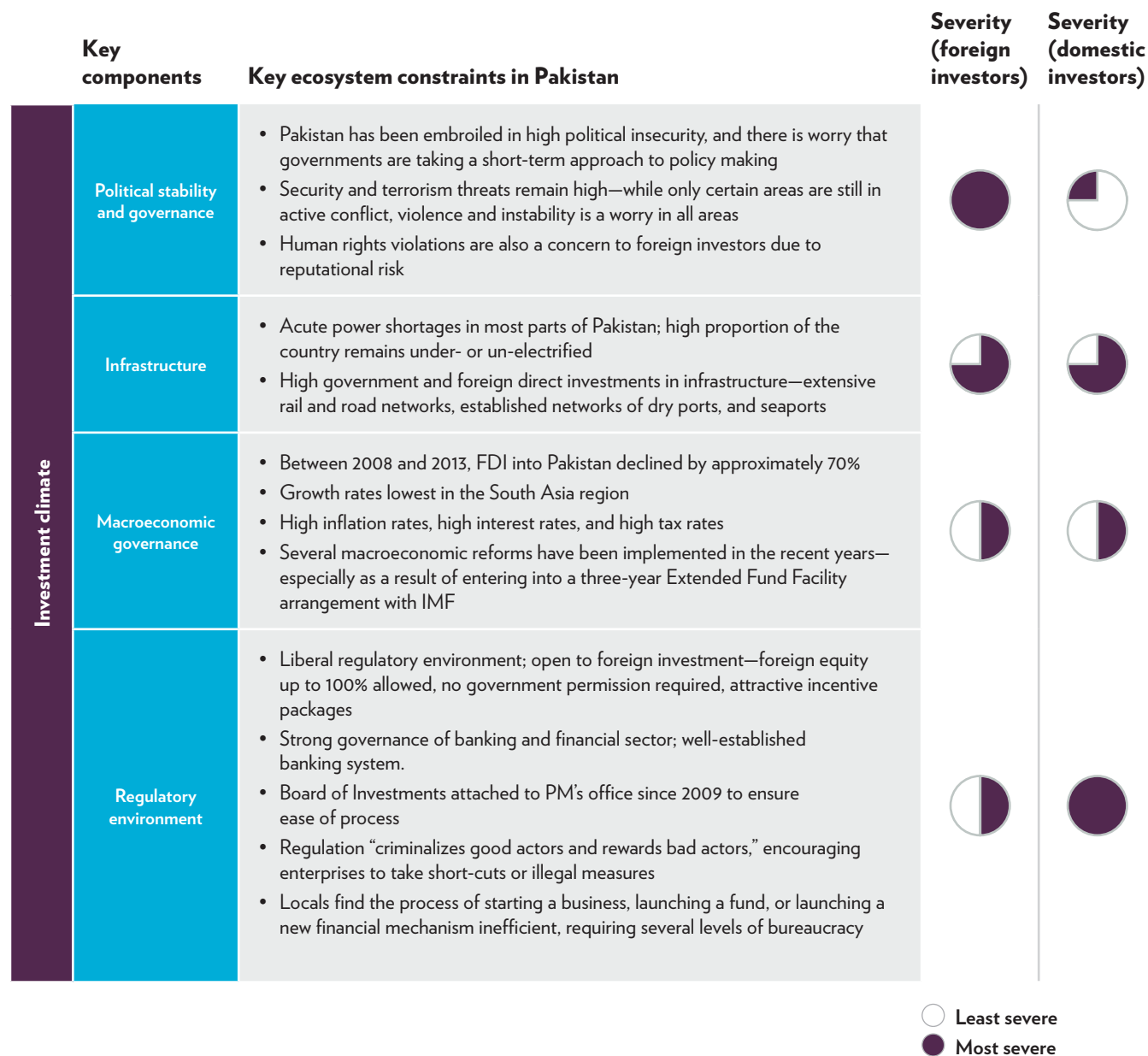
Given that Pakistan has largely maintained an open investment regime since 1997, the regulatory environment is generally perceived as favorable to foreign investors. However, the implementation of these regulations and the everyday experience of navigating them are reported as greater concerns for domestic investors. The Government of Pakistan (GoP) offers incentives to attract new foreign capital inflows, such as tax exemptions, reduced tariffs, and investor facilitation in designated special economic zones.⁸⁵ To continue attracting investment, the GoP also announced the 2013 Investment Policy, which further liberalized investment policies to almost all sectors. With respect to PE laws for foreign investors, the minimum initial capital investment required in all sectors—including services—was eliminated in the 2013 Investment Policy. There is currently no minimum requirement for the amount of foreign equity investment needed in any sector; moreover, there is no upper limit on the share of foreign equity allowed.

In contrast, domestic investors perceive challenges navigating the regulatory environment, including particular challenges around upholding contractual obligations, property registration, the settlement of tax disputes, and the management

⁸⁵ US Department of State, Investment climate statement, Pakistan, 2014.

and process of acquiring construction permits.⁸⁶ Moreover, domestic investors perceive and encounter corruption as a more significant issue than foreign investors, particularly with respect to government procurements and establishing a business. While Pakistani law provides criminal penalties for corruption, implementation of the law is incomplete, and thus, in practice, it forms a significant barrier to smooth and efficient business operations.⁸⁷

FIGURE 24: INVESTMENT CLIMATE OVERVIEW BY SEVERITY RATING



Sources: 2014 Investment Climate Statement, Pakistan (US Department of State); Dalberg analysis

86 World Bank 2014 “Doing Business” rankings; Pakistan and US Department of State (2014).

87 Pakistan ranked 127th of 177 countries in the Transparency International Corruption Perceptions Index (2013).

With respect to macroeconomic governance, Pakistan has a liberal foreign exchange regime and its policies support the free flow of resources for domestic and foreign investors,⁸⁸ but its taxation and inflation rates remain a significant barrier for both foreign and domestic investors. Investors are faced with a complex assortment of both federal and provincial taxes and controls, which are overseen with much administrative discretion, resulting in inefficiency and corruption. The GoP and the World Bank launched a multi-year tax reform program in 2004 that was extended until 2011; while there are still major issues with the taxation system, this initiative helped the GoP reorganize its Federal Board of Revenue in establishing a large tax unit. However, political tensions prevented the GoP from presenting an IMF-mandated tax measure to the Parliament in 2010, and Pakistan's tax-to-GDP ratio still remains among the lowest worldwide. In addition, the other macroeconomic barriers faced by investors include high inflation and a relatively volatile currency that can depreciate dramatically.

In terms of investor support, there are an increasing number of service providers, and a network of ecosystem support players is developing quickly (see Figure 25). However, there is still a range of issues that need to be addressed, particularly for incoming investors with respect to deal sourcing and due diligence, as they are restricted by security concerns in their ability to undertake due diligence and pipeline development on the ground. Due to the fact that the investor advisory services landscape is still thin, equity investors provide informal advisory support through their participation on investee boards.

⁸⁸ *US Department of State, Investment climate statement, Pakistan, 2014.*

FIGURE 25: CONSTRAINTS TO INVESTOR AND ENTERPRISE SUPPORT IN PAKISTAN

Key components	Key ecosystem constraints in Pakistan	Severity of constraint
<div style="writing-mode: vertical-rl; transform: rotate(180deg);">Investor and Enterprise support</div>	<ul style="list-style-type: none"> • Presence of general service providers (e.g., for legal, accounting, and registration support); however, few specialized investment advisory firms are present that can help with specialized functions such as deal sourcing and due diligence • Key areas of need include <ul style="list-style-type: none"> » Firms that can do due diligence on the ground, given security concerns that prevent investors from traveling to Pakistan » Need for firms who can help investors with pipeline development given closeness of social and business networks and importance of relationships to navigate these » More asset management support providers or BDS providers that can work with international equity investors who are wary of setting up a local presence due to security risks 	
	<ul style="list-style-type: none"> • Other than access to finance, key challenges for enterprises include access to markets, difficulty in hiring and retaining qualified staff, and security concerns • While there is a growing presence of enterprise support and development organizations, including incubators, accelerators, and BDS providers, the overall landscape is still developing • A few new aggregators are emerging who help enterprises access support • Key areas of need include: <ul style="list-style-type: none"> » Vocational/skills training institute to increase pool of qualified staff » Increase in the number of BDS providers » More incubators and accelerators, especially having a non-tech focus » Efforts to change mindset about working at SMEs 	

○ Least severe
 ● Most severe

Sources: Stakeholder interviews; Dalberg analysis

The enterprise support ecosystem is also growing, with a number of incubators and accelerators (particularly those with a focus on technology enterprises) established over the last few years, as well as support from traditional providers and funders of technical assistance (donors and DFIs). While a positive trend, and one that creates investor confidence and optimism, there is still a lot to do to fully establish these support players and, more importantly, to ensure a good quality of service. As with all nascent ecosystems, in the rush to create new support organizations for enterprises out of the recognition of a serious need, the quality of service and the impact of these organizations may not be a foremost concern but will be an important area of focus going forward.

FIGURE 26: SAMPLE ORGANIZATIONS IN PAKISTAN'S SUPPORT ECOSYSTEM

Incubators/Accelerators



** Beyond these organizations there are several co-working spaces such as DotZero, Basecamp, etc. that offer passive support*

Advisory Services



Credit Rating Services



TA Providers



Sources: Stakeholder interviews; Investor websites; Dalberg analysis

AREAS FOR FURTHER RESEARCH

There are several areas of further research that would amplify our understanding of the vibrant impact investing landscape in Pakistan.

First, given the investor interest in innovative financial instruments, such as quasi-equity, social impact bonds, and murabaha, additional research on these would be beneficial to address the problem of the lack of familiarity among regulators and enterprises. Issues to be explored include a) a detailed overview of instruments employed in current investments, b) conditions under which various instruments are ideal, c) examples from other countries that could be replicated in Pakistan, and d) the necessary requirements for investors to engage in these instruments.

Second, it would be important to further understand the critical role of HNWIs and family offices in Pakistan, including clarity on who is investing in what. As we know now, these stakeholders either primarily engage in philanthropic activities or in conventional commercial investments. Further research that focuses on the requirements that would stimulate or compel impact investments would be interesting.

Third, given a regulatory openness to foreign investment but a need for local presence for effective capital deployment, there exists an opportunity to explore methods for collaboration among foreign and domestic investors and ecosystem players. Further research can explore how these stakeholders can combine their respective resources and strengths to develop the impact investing market in Pakistan.

Lastly, additional resources on intermediary ecosystem players, including those that support both enterprises and investors, would be of value. A catalogue of intermediary support organizations for enterprises (e.g., organizations that support the structuring of deals) as well as service providers for investors (e.g., providers who conduct due diligence on investees) would significantly help in generating awareness of the players in this market. While there has been an increase in the number of such support organizations, the quality of their service and their impact is unknown. A landscape of optimal models and specific organizations, as well as best practices, could strengthen the ecosystem for enterprises and investors alike.

SRI LANKA



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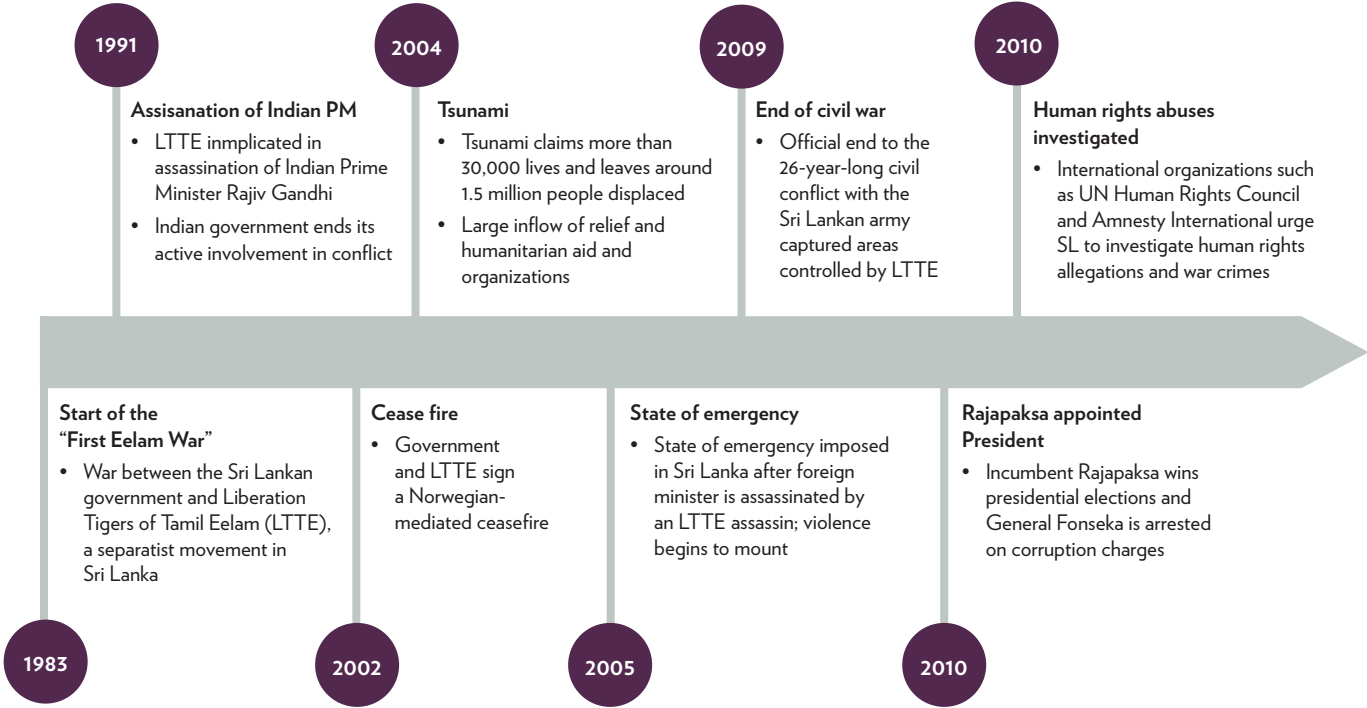
COUNTRY CONTEXT

Overview

Sri Lanka, a country that has recently emerged from a 26-year-long civil war, is now showing signs of strong recovery and positive economy-wide growth. Since the end of the civil war in 2009, the country has experienced dramatic GDP growth and is forecasted to grow at nearly 8.5% annually through 2016.⁸⁹

Throughout the period of the civil war, in addition to widespread political instability and insecurity, Sri Lanka suffered from several natural disasters, including a devastating tsunami in 2004. As a result, there was a heavy inflow of international aid into the country. More recently, however, allegations of human rights violations by the government have made many of these aid organizations wary of engaging in Sri Lanka. Some have, in fact, begun withdrawing from the country, and there has been a continued push from the international community for investigations into these allegations.

FIGURE 1: TIMELINE OF KEY EVENTS IN SRI LANKA'S POLITICAL HISTORY



Source: BBC, 2013. Sri Lanka Profile

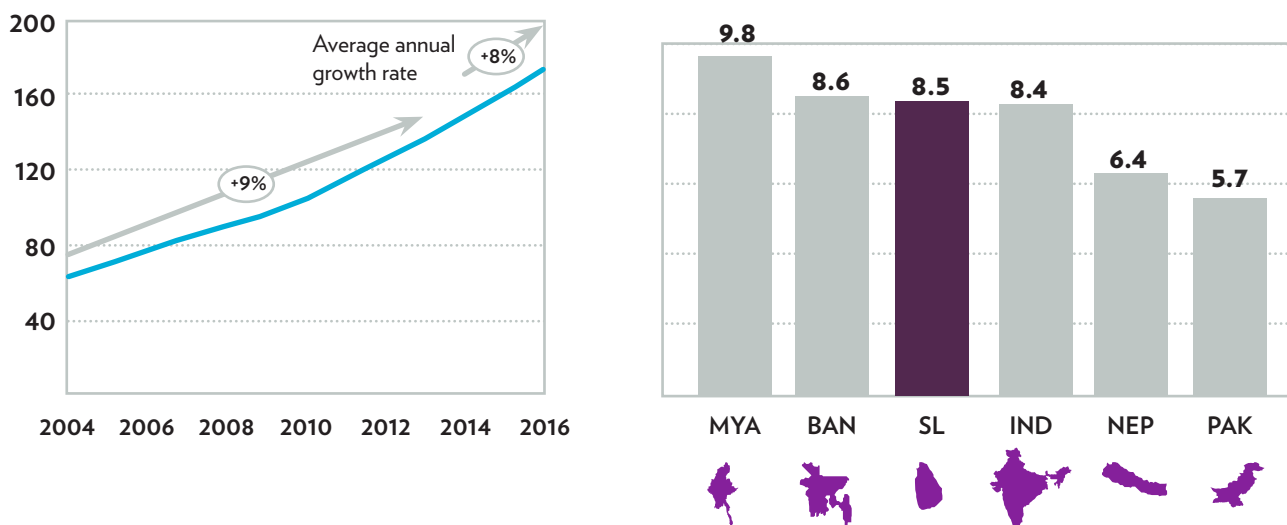
⁸⁹ International Monetary Fund estimates.

The implications of these changes for investors are mixed. The improved political climate and engagement by government are promising, but the scrutiny of the international community presents reputational risk and, as such, many potential investors are wary. Still, strong macroeconomic fundamentals, including rapid current and forecasted GDP growth, are positive indicators.

GDP growth and drivers of foreign direct investment (FDI)

Sri Lanka is predicted to be one of the fastest growing economies in Asia. Sri Lanka's GDP in 2013 was 136 billion (PPP, current international \$) following nearly a decade of average annual growth of 9%. At a forecasted GDP growth rate of 8.5% from 2014 to 2016, Sri Lanka is poised to be the third fastest growing economy in the region, behind Myanmar and Bangladesh but ahead of India.

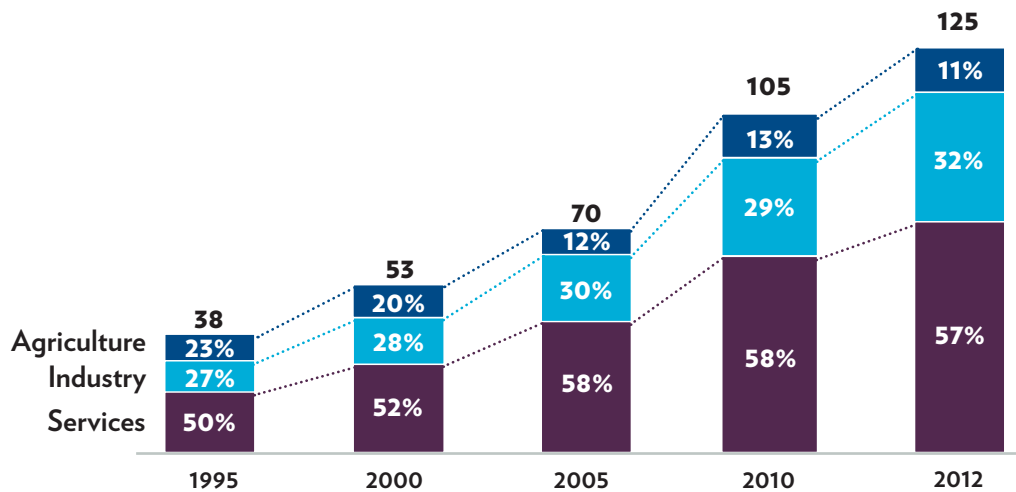
FIGURE 2: GDP GROWTH OVER TIME (PPP, CURRENT INTERNATIONAL DOLLAR BILLIONS) AND 2014-2016 FORECASTED GROWTH RATE AS COMPARED TO REGION (%)



Sources: International Monetary Fund estimates; Dalberg analysis

Service sector growth has been the strongest contributor to this economic performance. In 2013, industry contributed to 32% of GDP (strongly driven by the textile and garments, and food and beverage sectors) while services such as tourism, transport, telecommunications, and financial services contributed to 57% of the GDP. Tourism in particular showed strong growth—tourism income rose from USD 362 million in 2005 to USD 1.04 billion in 2013, and is expected to double again in the next five years. Interestingly, while agriculture only contributes a small share of GDP, approximately 32% of the population is employed in the sector, and Sri Lankans still view their country as heavily agricultural, with even formal sector workers retaining ownership of agricultural land that they return to during harvest season to help harvest the yield.

FIGURE 3: CONTRIBUTION TO GDP BY SECTOR (PPP, CURRENT INTERNATIONAL DOLLAR BILLIONS)⁴



Source: World Development Indicators, The World Bank

Alongside this robust growth, the Sri Lankan government has developed a strong provision of basic services for the public. Public expenditures on education, housing, healthcare, and other services more than doubled from 2005 to 2012 and accounted for 22% of government revenue as of 2012. Expenditures on public services are expected to increase further, improving both access and quality. While there is increasing private interest in serving the high-end market segments, the widespread and good-quality public provision of basic education and healthcare for lower- and middle-income segments makes these sectors less attractive to the private sector (although some regional variation and inequity are still visible).

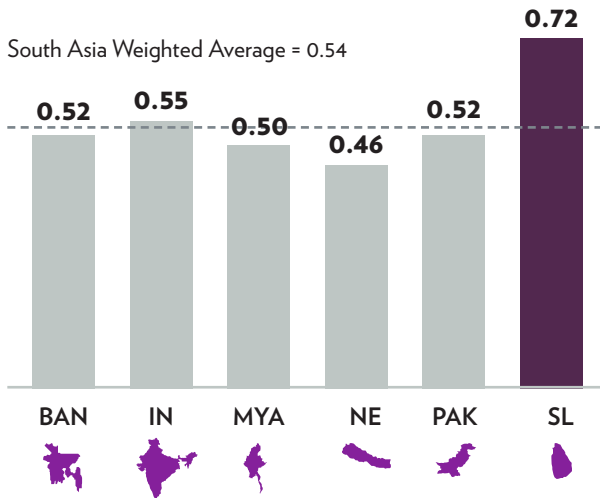
Widespread public sector provision has also resulted in Sri Lanka's Human Development Index (HDI) score of 0.72, which is much higher than the South Asia weighted average (0.54) and all regional comparators. Life expectancy at birth is now 75.1, higher than the world average of 70.1. Ninety-three percent of the population has access to improved drinking water, compared to 89% for the world average.

⁹⁰ Services, Industry, and Agriculture are used as defined by ISIC Rev 3. Services include wholesale and retail trade (including hotels and restaurants), transport, and government, financial, professional, and personal services such as education, healthcare, and real estate services. Industry includes mining, manufacturing, construction, electricity, water, and gas. Agriculture includes cultivation of crops, livestock production, forestry, hunting, fishing, and other associated activities.

FIGURE 4: HUMAN DEVELOPMENT INDEX FOR SOUTH ASIA

HUMAN DEVELOPMENT INDEX
(SCALE OF 0 TO 1, 1 BEING THE HIGHEST)

South Asia Weighted Average = 0.54



HEALTHCARE

- Life expectancy at birth is now 75.1, higher than world average of 70.1, and within the high development index category (>73.4)
- Infant mortality rate is 8 per 1000 live births and 99% of births are attended by a healthcare worker

EDUCATION

- Sri Lanka's expected years of schooling for a student starting school is 12.7 and mean years of schooling for adults is 9.3; these figures are both more than South Asia and World averages, and within the medium human development index category
- Literacy rates among men and women are 97.7% and 98.6% respectively

WATER AND SANITATION

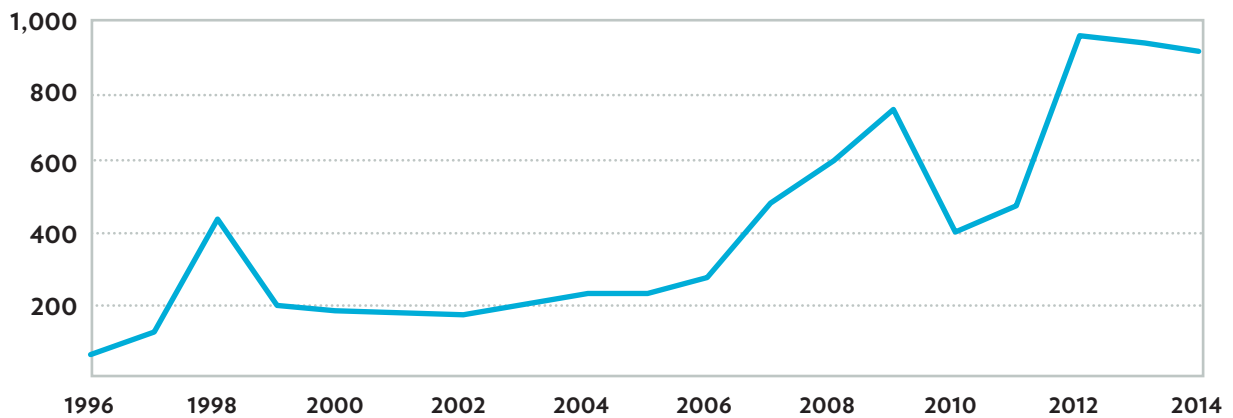
- 93% of the population have access to improved drinking water sources and 91% of the population have access to improved sanitation, both of which are higher than the world averages of 89% and 63%, respectively

Sources: UNDP, 2013 Human Development Index; UNICEF 2013 Sri Lanka Statistics

Investors have generally responded positively to the stability and growth in Sri Lanka.

FDI inflows have been volatile but increasing since the mid-2000s, rising to USD 1.2 billion in 2013. Key constraints to increased investor confidence and smoother, stronger FDI inflows include concerns over growth being fueled primarily by government infrastructure spending, concerns over limited action to address allegations of human rights violations, and allegations by some investors of corruption and inconsistent application of investment policies.⁹¹

FIGURE 5: FDI INFLOWS TO SRI LANKA OVER TIME (CURRENT USD MILLIONS)



Source: World Development Indicators, The World Bank

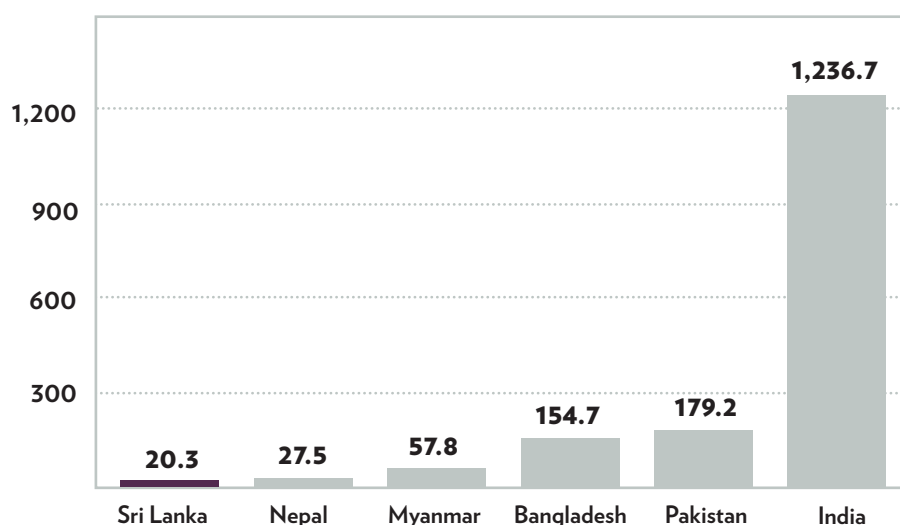
⁹¹ News reports: Ranga Sirlal, "Sri Lanka targets \$2 Bln in FDI again for 2014." Reuters, May 29, 2014.

Key constraints in Sri Lanka

Despite a relatively high HDI score, a large majority of Sri Lanka's population still lives below USD 4 per day (70% in 2011), and a quarter lives below USD 2 per day.⁹² Income inequality is high, although it varies significantly by region. The Gini coefficient⁹³ for Sri Lanka is 0.36 (compared with the South Asia average of 0.33), and it is estimated that the richest 20% earn 45% of the income while the poorest 20% earn only 7%. Eighty-five percent of Sri Lanka's population lives in rural areas, and this statistic has remained fairly constant since 2009.⁹⁴

One other key factor deterring investors from investing in Sri Lanka is the small size of the population and the domestic market. With a population of just over 20 million, Sri Lanka is the smallest of all countries in South Asia. This small domestic market means opportunities for local scale are limited. Although Sri Lanka does enjoy geographic proximity to India and its large market, the advanced nature of many Indian industries means that Sri Lankan businesses struggle to compete there.

FIGURE 6: 2012 TOTAL POPULATION BY COUNTRY (IN MILLIONS)



Source: World Bank Development Indicators, The World Bank

⁹² World Bank 2011; ECHO 2012.

⁹³ The Gini coefficient represents the income distribution of a nation's residents. This is the most commonly used measure of inequality. The coefficient varies between 0, which reflects complete equality, and 1, which indicates complete inequality. Source: Wikipedia, http://en.wikipedia.org/wiki/Gini_coefficient.

⁹⁴ Rural Poverty Portal, *Rural Poverty in Sri Lanka*.

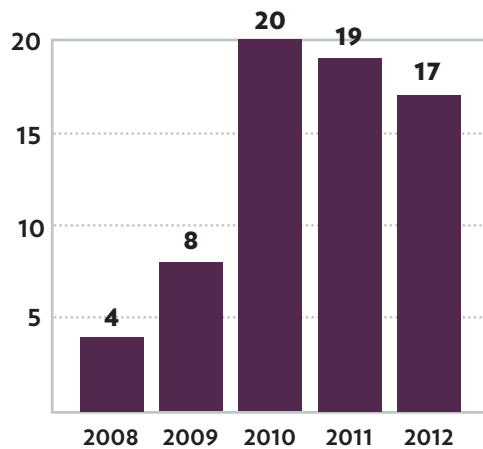
Sri Lanka's stock market is also relatively small in terms of market capitalization.

The market saw huge year-on-year growth between 2008 and 2010, but then contracted as investor confidence dropped (Figure 7). In 2011–2012, there were several cases of market manipulation reported in the media—including allegations of price manipulation and insider trading—which have left domestic and foreign investors wary. The markets have been recovering only sluggishly since.

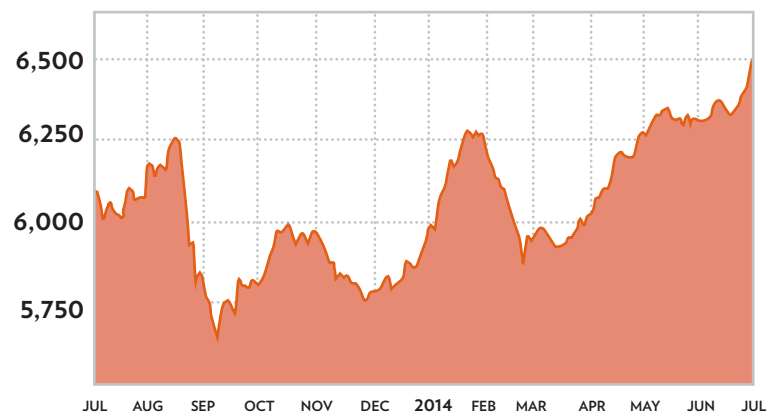
Furthermore, capital markets are perceived to be extremely volatile, which again acts as a deterrent for investors. This holds true even for foreign investors for whom public equities would otherwise present an easier, lower-risk asset class with which to enter and gain country exposure.

FIGURE 7: SRI LANKA TOTAL MARKET CAPITALIZATION (USD BILLIONS) AND COLOMBO ALL SHARE INDEX OVER TIME (USD, JULY 2013–JULY 2014)

TOTAL MARKET CAPITALIZATION OF LISTED COMPANIES (CURRENT USD BILLIONS)



PRICE OF SRI LANKA COLOMBO STOCK EXCHANGE: ALL SHARE INDEX (USD, JULY 2013 TO JULY 2014)

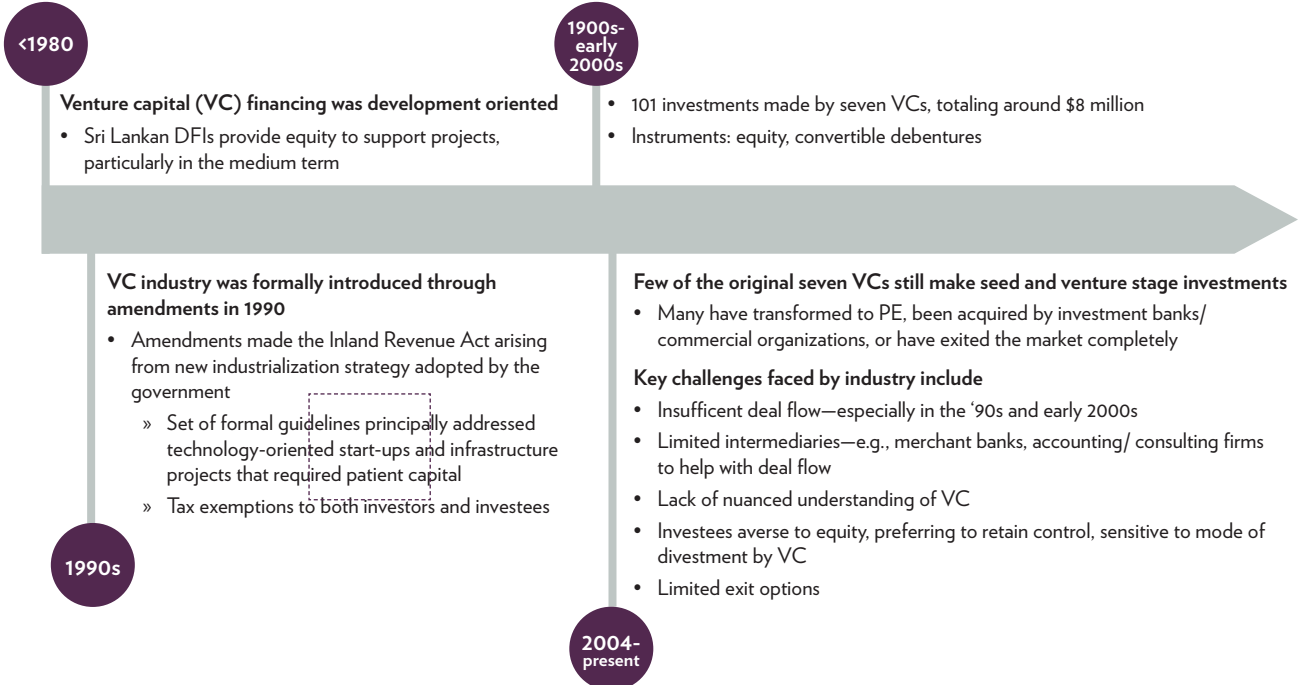


Sources: World Development Indicators, The World Bank; Bloomberg Stock Market and Financial Markets Overview.

Interestingly, Sri Lanka has a fairly long history of institutional venture capital. In the 1990s, the government recognized the need for increased risk capital in the market and encouraged banks to establish venture capital (VC) investment arms.

Through the 1990s and into the early 2000s, 101 investments were made by seven VCs, totaling around USD 8 million. However, few of these seven VCs still exist, and the practice of investing risk capital has never truly become embedded in the economy. The investments made during this period were fairly high risk, and returns were not strong, in part due to the limited experience of fund managers at the time, and in part due to aversion on behalf of strong entrepreneurs to open their ideas and companies to bank-linked VCs out of fear that they would be taken over (see Figure 8 below). Therefore, these early VC funds have either morphed into more conservative private equity (PE) funds, been acquired by investment banks/commercial organizations, or closed down completely. Nonetheless, positive implications have been a greater familiarity with equity instruments and a relatively active (although small) mainstream PE market. However, the negative perceptions created by these unsuccessful efforts have left a sour taste for many domestic investors who remain wary of deploying risk capital.

FIGURE 8: PATHWAY FROM EARLY VC TO CURRENT CONSERVATIVE COMMERCIAL PE IN SRI LANKA



Sources: “Venture capital financing—Sri Lankan experience,” Lanka Ventures, 2004; Stakeholder interviews

More recently, there were a handful of attempts by both domestic and regional fund managers to raise a Sri Lanka-focused impact investing fund, but these too were unsuccessful for a range of reasons, as outlined in Figure 9. At least two to three funds have tried to raise capital in the past and have failed. The goal was to raise capital committed solely for Sri Lanka, out of recognition that capital committed for South Asia through regional funds was heavily directed to India. However, given the size and immaturity of the Sri Lankan market at the time (post-war) as well as the internal constraints on DFIs as limited partners (LPs), these attempts were unsuccessful. The International Finance Corporation (IFC), for example, had a USD 10 million mandate for investing into a fund, but this expired due to the inability to find co-investors for the fund.

FIGURE 9: CHALLENGES TO RAISING COUNTRY-SPECIFIC IMPACT INVESTING FUNDS FOR SRI LANKA

Challenge	Severity of Challenge	Explanation of Challenge
Difficulty raising LP capital		<ul style="list-style-type: none"> Attempts to raise funds right after the war were unsuccessful in part because they coincided with the global economic downturn, and in part due to the challenges of coordinating multiple DFIs to invest at the same time: <ul style="list-style-type: none"> » DFIs often have both minimum investment amounts into funds (e.g., \$10 million) but also limitations around their exposure within the fund and will only want to be 15–25% of the total—this means funds have to be large, and multiple anchor investors are needed. It is difficult to find co-investors who see the potential of Sri Lanka and have a similar mandate as DFIs to invest the other ~80% needed to start a country fund—the ability for the GP to co-invest provides a strong signal and credibility, allaying some LP concerns. For private investors who are still not familiar with the market and haven't seen any success, it seems too risky—so need DFIs as the anchors initially; private investors would prefer early exposure through public debt rather than private equity. Sri Lanka is also a smaller market compared to India, and so investors see a risk in having too large of a fund dedicated to Sri Lanka where they are unsure of pipeline potential and would prefer a regional fund that can invest in multiple markets.
Lack of experienced fund managers		<ul style="list-style-type: none"> Given the nascent opening up of the market, there are few fund managers who have experience in raising and running a fund—some stakeholders suggest that this lack of experience was a key part of the challenge in convincing early investors to participate in a fund. Many fund managers are expatriate investment professionals who see the potential of Sri Lanka and want to raise a fund.
Difficulty domiciling in Sri Lanka		<ul style="list-style-type: none"> Fund structure is relatively new in Sri Lanka, and there are no benefits provided to domicile there, as compared to Mauritius, which gives tax benefits. Repatriating money from Sri Lanka can also be difficult, making it harder for foreign investors to invest in a fund.

○ Least severe
 ● Most severe

Sources: Stakeholder interviews; Dalberg analysis

INVESTING IN SRI LANKA: THE SUPPLY SIDE

There is increasing interest and activity in Sri Lanka, which provides a number of advantages to investors compared to other countries in South Asia. Compared with its neighbors, Sri Lanka has perhaps the easiest regulatory environment to navigate, which gives investors the required confidence in their ability to invest and exit. Another key feature of the market is the growing maturity of entrepreneurs—primarily in terms of the diaspora/returnees who tend to be active and the domestic business community that has grown businesses over a long time. The small size of Sri Lanka—in terms of both market and geography—is both an advantage and a disadvantage. It is an advantage in that it is easy to identify entrepreneurs and partners as networks are strong and easy to access, and in the ease of getting around the country to rural areas to work with a diversity of enterprises. On the other hand, in such a small market, scale becomes a challenge as the domestic economy is limited and investors sometimes need to find deals that present opportunities to scale offshore.

The broad impact capital market in Sri Lanka

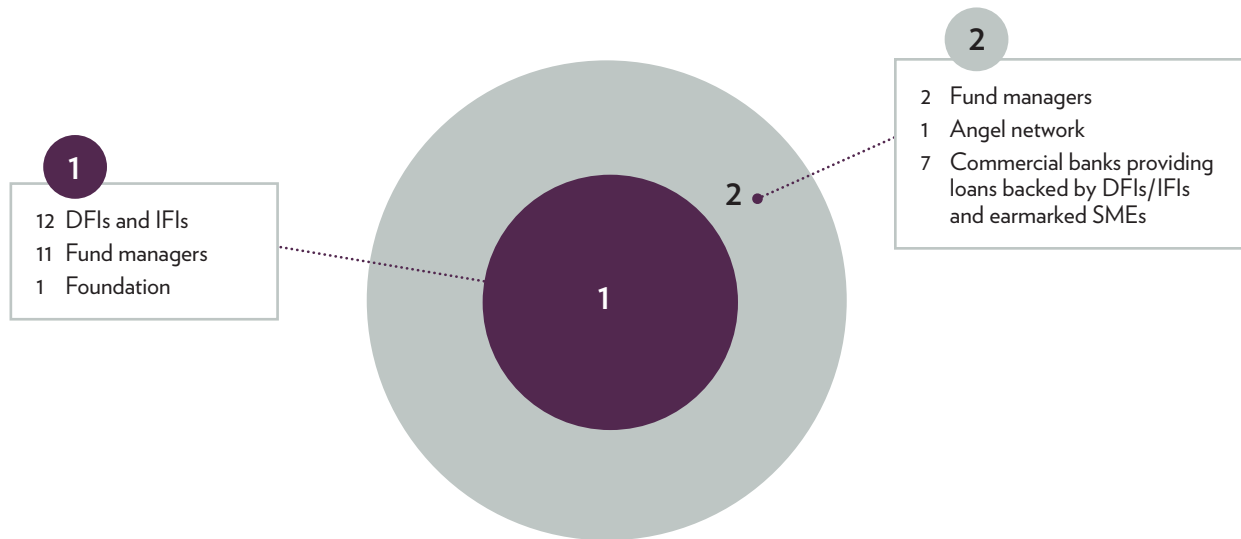
USD 386 million has been deployed to date by DFIs and a further USD 100 million has been deployed by other impact investors⁹⁵ (see Figures 10, 11 and 13). At least 12 international finance institutions (IFIs) and development finance institutions (DFIs), 11 funds, and one foundation have active impact investments in Sri Lanka. These investors have a total of 31 current investments. More information on the observed investment preferences for this set of investors can be found in the section “*Key trends of impact investing in Sri Lanka.*”

Overall, despite the large number of actors, the total volume of impact capital deployed is not proportionally large as compared to other regional markets.

Given the small size of the market, the deal sizes for both funds and DFIs tend to be smaller in Sri Lanka than in other countries in the region. Moreover, while there are a large number of DFIs active in Sri Lanka (as many as are currently active in India), several have engaged only through syndicated loans with other DFIs; therefore, the number of deals made overall is relatively small.

⁹⁵ *These Figures represent the best effort to scope the total impact investing market in Sri Lanka. However, it is possible that not all impact capital has been captured due to investor confidentiality or other limitations. These figures should be treated as approximate representations of the market.*

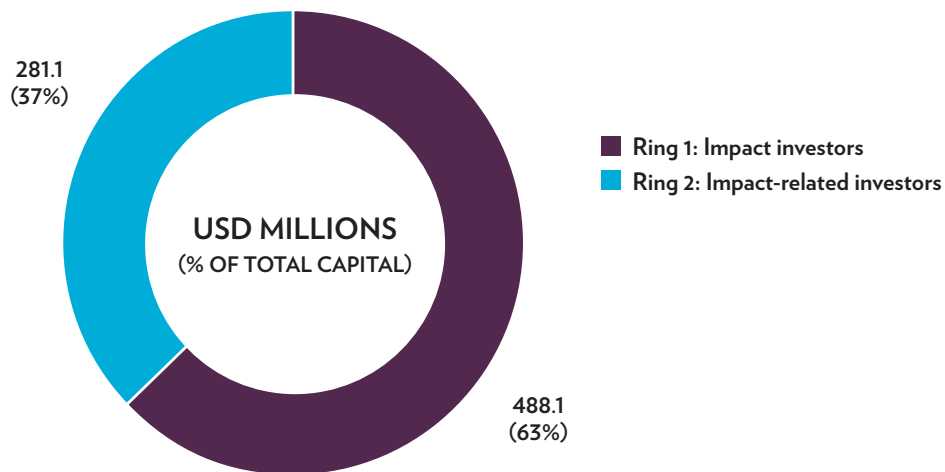
FIGURE 10: NUMBER OF DIRECT IMPACT AND IMPACT-RELATED INVESTORS IN SRI LANKA



Sources: Stakeholder interviews; Investor websites; Dalberg analysis

There are also a set of impact-related investors (Ring 2) with approximately USD 281 million invested (Figure 11). These investors include two fund managers, one angel network, and commercial banks lending to small or medium enterprises (SMEs) with DFI-backed capital. This group currently has 22 known investments, but the number is probably very high due to sizeable capital being used for SME loans by commercial banks. As there is no portfolio information publicly available for these, the exact number of investments made is unknown.⁹⁶

FIGURE 11: TOTAL KNOWN CAPITAL DEPLOYED BY RING



Sources: Stakeholder interviews; Investor websites; Dalberg analysis

⁹⁶ See “Defining key terms and concepts” in the introduction chapter of this report for an explanation of the framework used for categorizing investors using a two-ring framework, where the inner ring—Ring 1—represents the impact investing activity and the outer ring—Ring 2—represents the activity related to impact investing but lacking either an explicit impact intention or measurement.

Active impact and impact-related investors in Sri Lanka

Sri Lanka has a large number of actors and varied investor types with a mix of both local and international players. Figure 12 provides specifics on the active impact investors in Sri Lanka, which includes funds managers, DFIs, foundations, family offices, HNWIs, and banks.

There are significantly more international investors than domestic investors in the impact investment market (as domestic investors tend to be commercially oriented rather than impact focused), but these investors are only deploying a small share of their total capital in Sri Lanka. Of the 13 funds currently active, one is a domestic fund, two are regional (i.e., focused on South Asia), and ten are international. Traditionally, local funds in Sri Lanka have prioritized financial returns and had little interest in the impact investment market. While we see a large number of international funds deploying impact capital, the small size and uncertainty of the Sri Lankan economy have led these investors to invest only a small share of their portfolios in the country. A few additional funds are currently raising small amounts of domestic capital, although these will likely fall within Ring 2 in our framework.

DFIs and IFIs are the most active investors by amount of capital deployed, with all 12 DFIs/IFIs making investments directly into enterprises. DFIs/IFIs are responsible for USD 386 million, or about 79%, of the USD 488 million deployed by impact investors. While the amount of capital is sizeable, the number of companies absorbing this capital is not. To minimize their risks and due to the difficulty in finding large, investable companies, most DFIs/IFIs have invested only in syndicated loan deals with other DFIs/IFIs, implying that the number of enterprises receiving DFI/IFI capital is actually quite small.

DFIs and IFIs are also engaging indirectly in the impact-related market by channeling capital through commercial banks for SME lending and in small amounts deployed through foreign funds as intermediaries. As we have seen throughout the region, DFIs and IFIs are heavily backing SME loans through commercial banks (through both loans and guarantees). Overall, 42% of capital deployed by DFIs in Sri Lanka has been invested into financial institutions, with the goal of increasing access to finance.

Unlike in many of the other countries under study, DFIs are not currently investing in any country-specific funds in Sri Lanka. However, this is to change in the near future as a new Sri Lanka-specific fund is being set up through a joint venture between a domestic bank and a regional fund manager.⁹⁷ As DFIs now understand the market better, they are ready to increase their exposure in the country by investing in local funds.

Foundations have mostly exited Sri Lanka; hence, we see only one foundation providing impact capital. Following the end of the civil war, the country faced a

⁹⁷ "Zephyr charts \$50-million Sri Lanka plan," *Economic Times*, 2014.

humanitarian crisis, and in 2004, the country suffered from a devastating tsunami. These events sparked a wave of philanthropic capital from foundations. Sri Lanka has since recovered and has transitioned to a middle-income country, reducing the perceived need. Accusations against the government of widespread human right violations have further isolated foundations. Thus, we see only one foundation actively deploying impact capital in Sri Lanka today.

A large number of high net-worth individuals (HNWIs) and family offices are active as investors primarily due to one domestic angel network with more than 70 members, but the amount of capital deployed by these investors is relatively small. Domestic and diaspora HNWIs and family offices have been engaged in the impact capital market, both as direct investors into enterprises and as contributors to funds. One angel network has about 70 members—including HNWIs and family offices—but despite their large number, the network has deployed less than USD 100,000. Of these members, 10–12 are from the region and the remaining are members of the Sri Lankan diaspora. Domestic HNWIs are likely to increase their engagement in the future, as a number of them have already pledged capital to upcoming domestic funds and are expected to make up a significant share of new domestic funds.

As in other countries in the region, family and friends are a significant source of seed and venture capital through informal investments that do not have set timelines or contracts. While the exact amount of capital deployed through family and friends is unknown, it is likely to be the predominant source of capital in these early growth stages.

The most active institutional investors are commercial banks lending DFI capital to SMEs; one pension fund is scoping the market. Seven commercial banks are investing on the periphery of the impact investing market by making loans to SMEs with DFI/IFI capital. As discussed above, DFIs and IFIs have provided capital to these banks that has been earmarked solely for SME lending in an effort to catalyze investments to these businesses, leading to economic growth and higher financial inclusion. Beyond banks, one pension fund is looking to back a domestic fund.

FIGURE 12: IMPACT INVESTORS AND IMPACT-RELATED INVESTORS ACTIVE IN SRI LANKA

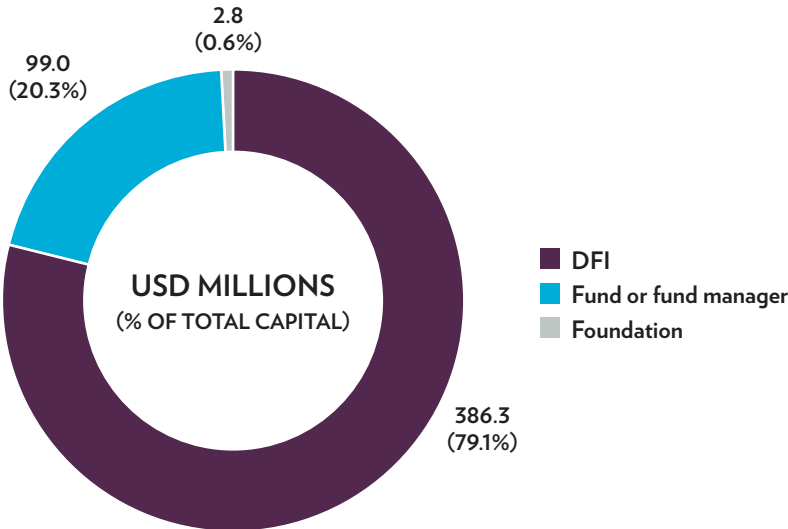
TYPE OF INVESTOR	ESTIMATED NUMBER	DETAILS OF INVESTORS IN SRI LANKA
Fund managers	13	Ten international funds (that have invested only a small share of their capital in Sri Lanka), one domestic fund, and two regional funds are currently making investments, and a few funds are scoping and preparing to launch in Sri Lanka.
DFIs and IFIs	12	All DFIs and IFIs are making direct investments into enterprises in Sri Lanka, and a few are also channeling capital through commercial banks for SME lending and investing small amounts in foreign funds.
Foundations	1	Only one international foundation is making investments in Sri Lanka, as many have exited the country with Sri Lanka being considered a middle-income country and facing concerns about human rights violations during the recently concluded civil war.
HNWIs and family offices	70+	Over 70 HNWIs and family offices are members of a domestic angel network, and several HNWIs have pledged capital to upcoming domestic funds. Family and friends are a predominant informal source of seed and venture stage capital.
Institutional investors	7 banks, 1 pension fund	Seven commercial banks are lending to SMEs with capital provided by DFIs. One pension fund is potentially backing a domestic fund.

Key trends in impact investing in Sri Lanka

The following section examines trends among impact investors, who collectively have about USD 488 million currently deployed. The activities of impact-related investors will be discussed in the section “Beyond the impact investing market.” Looking across the landscape of currently deployed capital in Sri Lanka, we can observe several trends in investment preferences of impact investors by instrument, stage of growth, sector, and deal size.

INVESTOR MIX

FIGURE 13: IMPACT CAPITAL DEPLOYED BY SOURCE (USD MILLION)



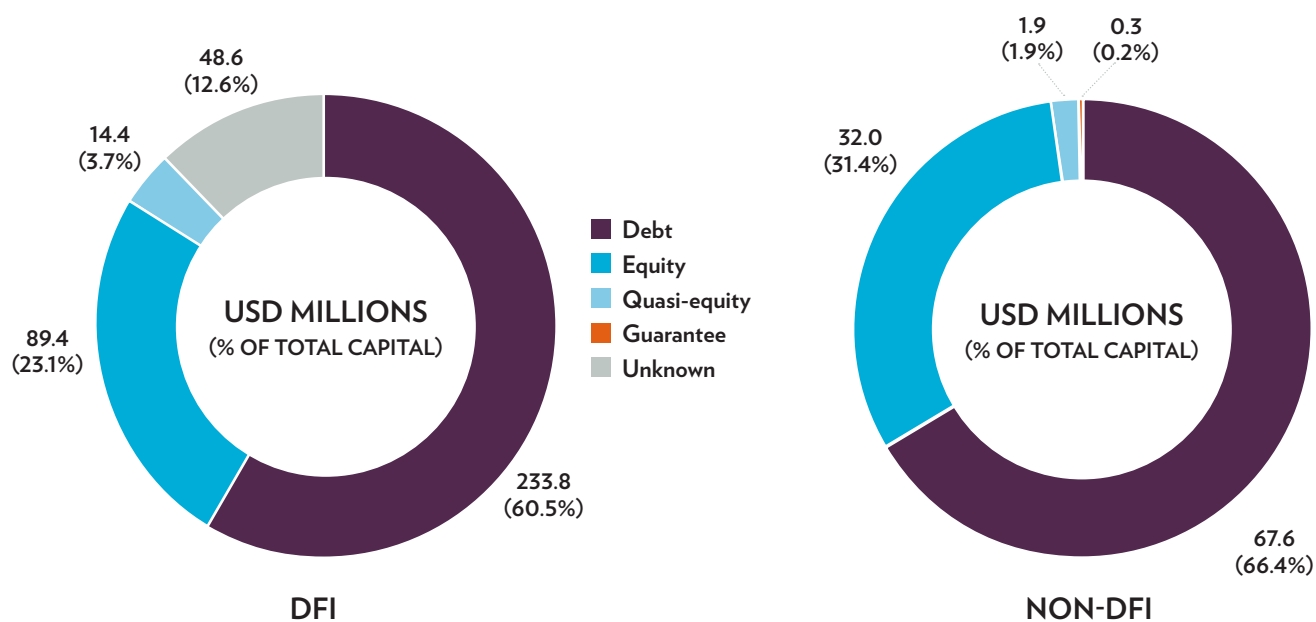
Sources: Stakeholder interviews; Investor websites; Dalberg analysis

DFIs and IFIs have the most capital currently deployed among impact investors (about 79%), with funds and foundations contributing the remainder. There are a large number of DFIs and IFIs active in Sri Lanka, but their prevalence in the market can also be explained by the large deal sizes that DFIs and IFIs tend to make relative to other investors. Funds and fund managers are also active, with USD 99 million currently deployed. One foundation makes up the remaining 0.6% of active capital among impact investors, with about USD 2.8 million deployed.

INSTRUMENT

Overall, impact investors in Sri Lanka have deployed more capital through debt than other instruments. Sixty-two percent of direct investments are debt, compared with 25% through equity. This is an interesting trend since equity is not a new concept to Sri Lanka (as described earlier), unlike in the other markets where both investors and enterprises are less comfortable with the instrument. This preference for debt is driven more by enterprise preference for debt than by investor preference, particularly for growth and mature stage companies, and is consistent across investor type—both DFIs and non-DFIs.

FIGURE 14: IMPACT CAPITAL DEPLOYED BY INSTRUMENT (USD MILLION)



Sources: Stakeholder interviews; Investor websites; Dalberg analysis

Investment instrument also partly depends on growth stage. Seed, venture, and growth stage companies have seen more equity investments from investors. Due to the inherent risk of earlier-stage companies, equity investments allow investors to be more strategically involved. Moreover, investors understand that in early stages, debt can actually constrain enterprise growth. In contrast, DFIs investing in large enterprises tend to invest through debt, driven largely by the capital needs of enterprises.

Investors are experimenting with new instruments. Besides debt and equity, which are more familiar instruments in Sri Lanka, impact investors have made some small to mid-sized guarantees to support access to finance for SMEs and non-bank microfinance institutions. Figure 15 provides an overview of investors providing guarantees; the IFC investments outlined in the figure do not qualify as direct investments into enterprises and therefore have not been captured in the totals in the analyses.

FIGURE 15: EXAMPLES OF GUARANTEES BEING USED BY IMPACT INVESTORS

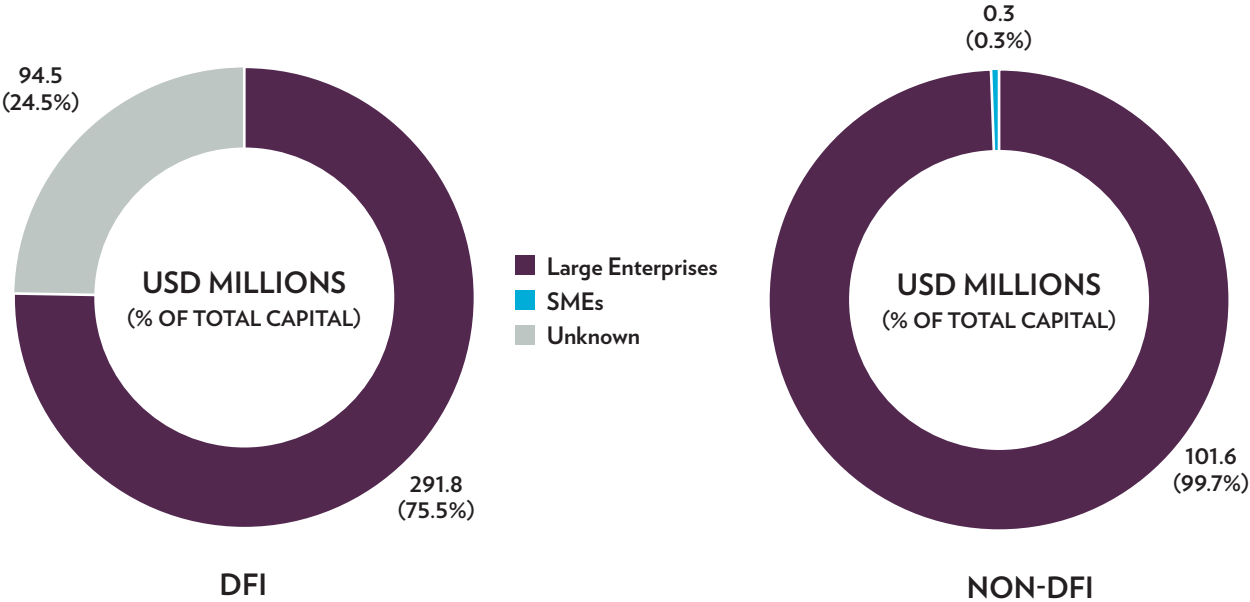
Investor Offering Guarantee	Organization Receiving Guarantee	Amount and Purpose
International Finance Corporation World Bank Group	Commercial Bank	<ul style="list-style-type: none"> • USD 14.87 million • Used to back SME loans provided by the bank
	NDB Bank	<ul style="list-style-type: none"> • USD 13.11 million • Used to back SME loans provided by the bank
Helps commercial banks increase their capacity and encourages SME lending. For DFIs, this is a less risky investment that creates a multiplier effect as commercial banks lend money to enterprises.		
Grameen Crédit Agricole Microfinance Corporation	Berendina	<ul style="list-style-type: none"> • USD 0.26 million • Help partially secure a bank loan from domestic bank for 3 years
Guarantees to Berendina Microfinance have been given to enable the enterprise to access commercial bank loans. The guarantee makes it easier for microfinance companies that lack collateral to access capital.		

Sources: Stakeholder interviews; Investor websites; Dalberg analysis

SIZE OF INVESTEE COMPANIES

A majority of impact capital has been invested in large companies. While it is expected that large companies will absorb the most capital, as deal sizes tend to be larger for these companies, only a very minimal amount of known capital (USD 300,000 or 0.1% of all capital) has flowed to SMEs. This is likely a function of the predominance of DFIs in Sri Lanka and their preference for large ticket sizes, which only relatively large companies can absorb.

FIGURE 16: IMPACT CAPITAL BY SIZE OF INVESTEE COMPANY (USD MILLIONS)

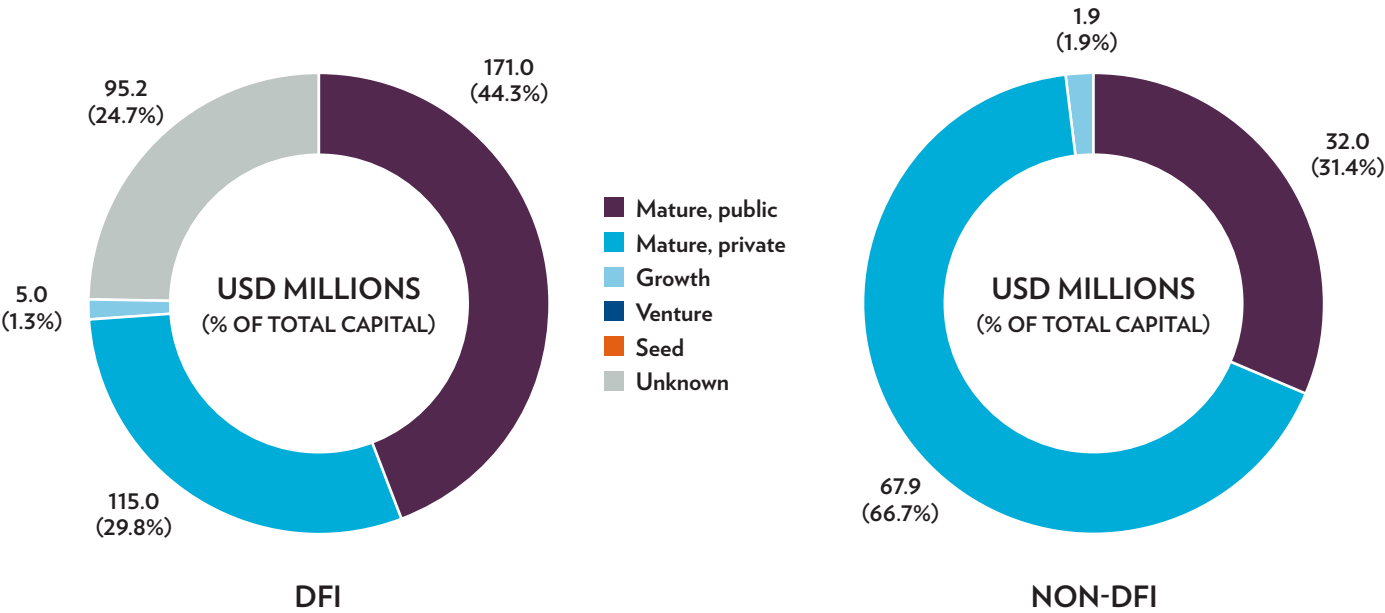


Sources: Stakeholder interviews; Investor websites; Dalberg analysis

GROWTH STAGE AND DEAL SIZE

As with the other markets under study, there is strong preference for mature companies—both listed and private—among all types of impact investors. DFIs need to make large investments and therefore, target enterprises that can absorb large amounts of capital, leading to a focus on larger and more mature companies. We also see non-DFI investors providing capital to listed and private, mature companies. As a result, 79% of total capital from impact investors has been invested in mature companies.

FIGURE 17: IMPACT CAPITAL DEPLOYED BY GROWTH STAGE

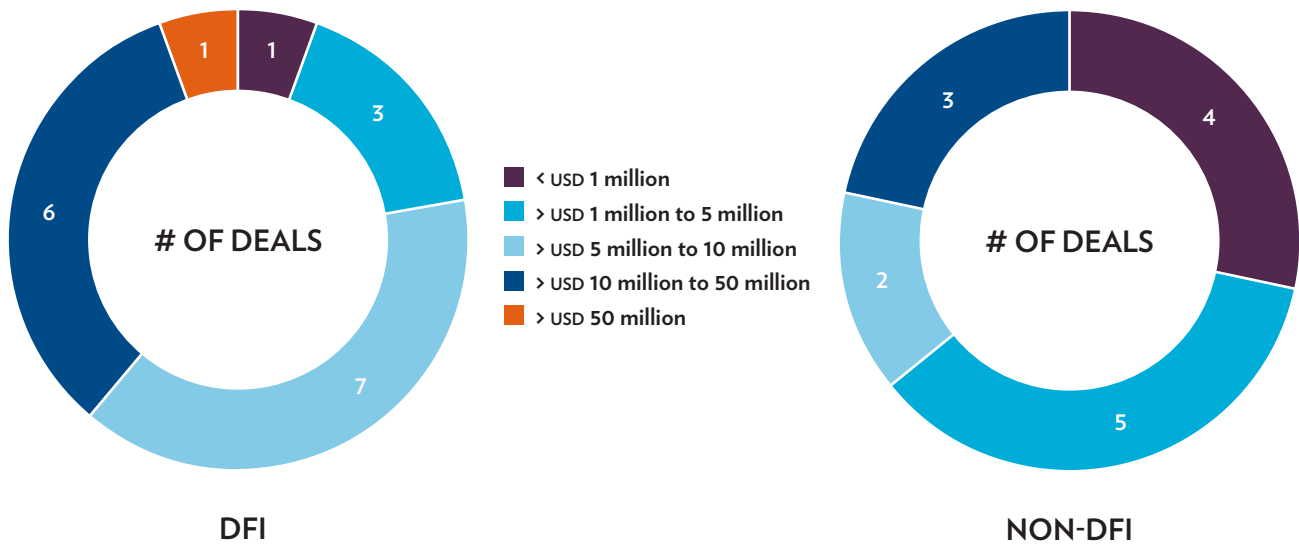


Sources: Stakeholder interviews; Investor websites; Dalberg analysis

While they still represent a small proportion of capital, angel investors, VCs, and bank SME portfolios (to a lesser extent), are targeting smaller and earlier-stage companies, despite the inherent higher risk. A major constraint to increased investment is the dearth of investible enterprises where the entrepreneurs have strong financial and operational management skills. Unlike in markets with established VC industries, in Sri Lanka, company directors (including equity investors) are personally liable in case of any default by the company. Therefore, for early-stage companies where the failure risk is extremely high, the appetite to take this risk is extremely low given the limited regulatory protection in case of bankruptcy. The result is that even angel investors or other seed and venture capital providers tend to be quite risk averse in their investment decisions and their decisions depend in great measure on their trust in and relationship with the entrepreneur.

Unlike in other markets, impact investments in Sri Lanka show wide variation in terms of deal size. A reasonable number of deals in each progressive size bracket suggests a growing maturity in the market and potential for development of the industry into a well-coordinated market with impact capital available across the range of capital needs.

FIGURE 18: IMPACT CAPITAL BY DEAL SIZE

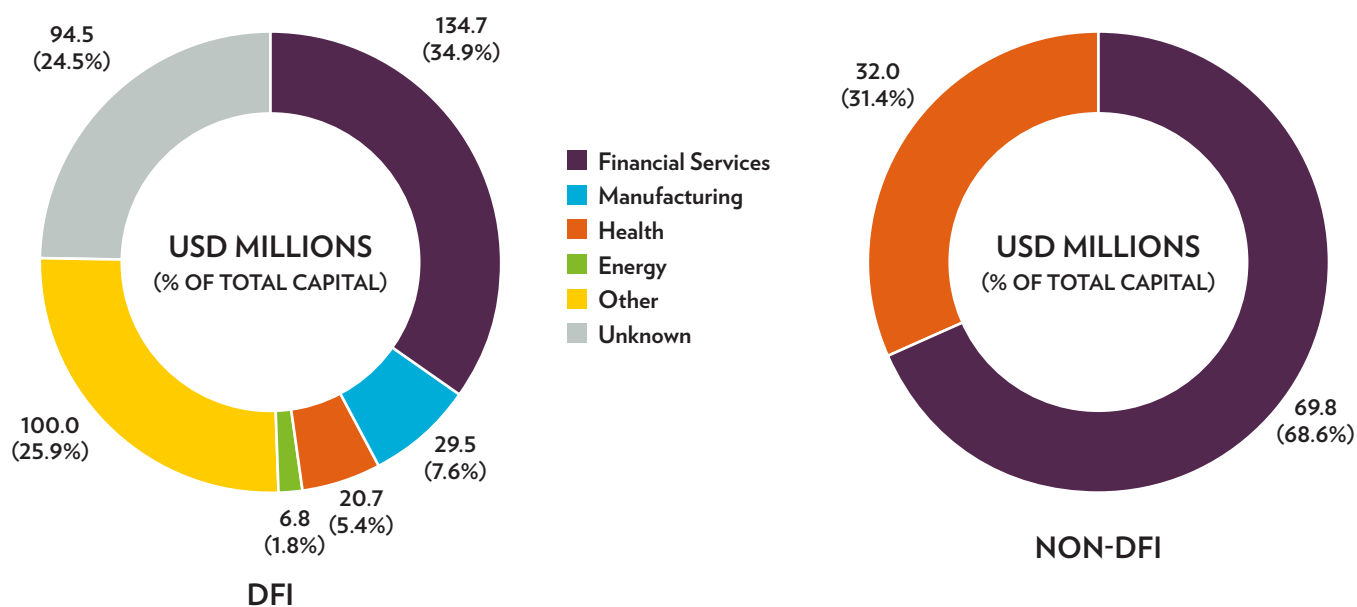


Sources: Stakeholder interviews; Investor websites; Dalberg analysis

SECTOR

In Sri Lanka, financial services and microfinance have drawn the bulk of impact capital by sector (where “financial services” includes banks and commercial leasing companies). Tourism and hospitality have also been attractive to investors, alongside some investment in high-end private healthcare. It is important to note that even within the financial services/microfinance sector, a handful of companies have been the target of the majority of investments—in part due to the legal structure of many microfinance organizations (as guarantee-limited companies that cannot absorb foreign capital, as will be discussed in later sections) as well as to some level of risk aversion and preference for partnering with investee companies that have already worked with international investors in the past.

FIGURE 19: IMPACT CAPITAL DEPLOYED BY SECTOR



Sources: Stakeholder interviews; Investor websites; Dalberg analysis

Certain sectors, particularly those that focus on base of the pyramid (BoP) segments, have seen limited interest to date. The key constraint to increased impact investment in the BoP-focused business models is the scale and capacity to absorb large investment. With the increase in investment activity in relatively small ticket sizes (largely by investors in Ring 2), impact capital directed to businesses focused on the BoP is likely to grow. In particular, we observe an interest in BoP-focused enterprises in the sectors of ICT, energy, healthcare, and technology. At present, with the concentration of actors in large deal sizes, investment in these sectors has been limited.

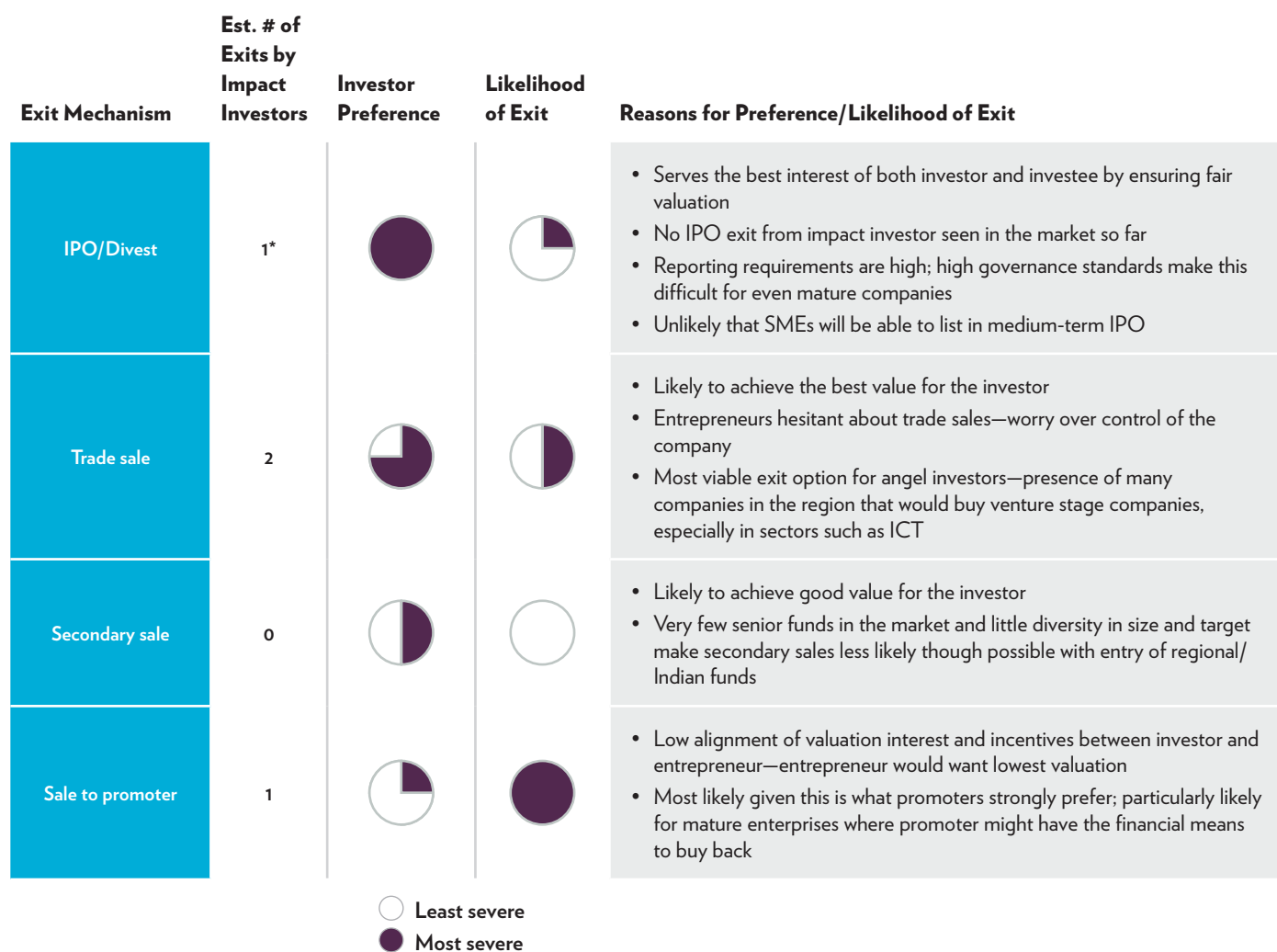
Return expectations and exit possibilities

Equity investor return expectations are between 20% and 25%. Commercial bank interest rates in Sri Lanka are typically pegged at 8%–12%, and other asset classes such as fixed deposits or government securities provide similar returns up to about 12%. Equity investors, on the other hand, expect returns that are adjusted for a higher level of perceived risk. For PE/VC funds, this is usually 20%–25%. This figure might be slightly lower for DFIs, but most impact investors target returns as close to market rates as possible.

Some entrepreneurs have stated concerns about having limited access to below-market impact equity, which they believe should have lower financial return expectations to account for the value of the social/environmental impact. For example, agricultural enterprises articulate a preference for a greater share of their profit/value return to the farmers, resulting in a lower return to investors as well as difficulty in incorporating a dividend payout. However, in general, low investor competition in the market increases confidence that these high returns will be possible.

In terms of exits, investor preferences are not always aligned with likely mechanisms, given the contextual and circumstantial realities (Figure 20). As commonly seen in other countries, IPO is the preferred means of exit, but has not been used widely among impact investors to date. There have been no exits through IPO for impact investments (with the exception of one investment in a publicly listed company, which was later exited). Instead, trade sale and owner buyback are more viable exit options.

FIGURE 20: INVESTOR PREFERENCE FOR EXIT MECHANISMS IN SRI LANKA



Source: Dalberg analysis; * Note: Thus far, the market has not seen a genuine IPO exit; in this case, the investee company was already a publicly listed company before impact equity investment.

Impact measurement

With respect to impact measurement, impact investors tend to use established measurement systems for their investments in Sri Lanka. Given that there is only one Sri Lanka-specific fund and the majority of investors in Sri Lanka have more established investments elsewhere in the region, there are very few nuances to impact measurement specific to Sri Lanka, differentiating this market from the others.

DFIs and funds receiving DFI capital tend to have more defined metric systems (generally, an ESG framework) to measure impact, with job creation as a key metric. For funds, measuring impact is typically seen as a lower priority than managing the business and financial aspects of their investments. Social impact is primarily measured by economic metrics (for example, number of jobs created, products sold,

and amount of money disbursed) with the assumption that economic impact will have social impact.

Anecdotal assessment, including stories of lives touched and benefits to entrepreneurs, is often used while funds are in the process of developing tailored metrics for a specific investment.

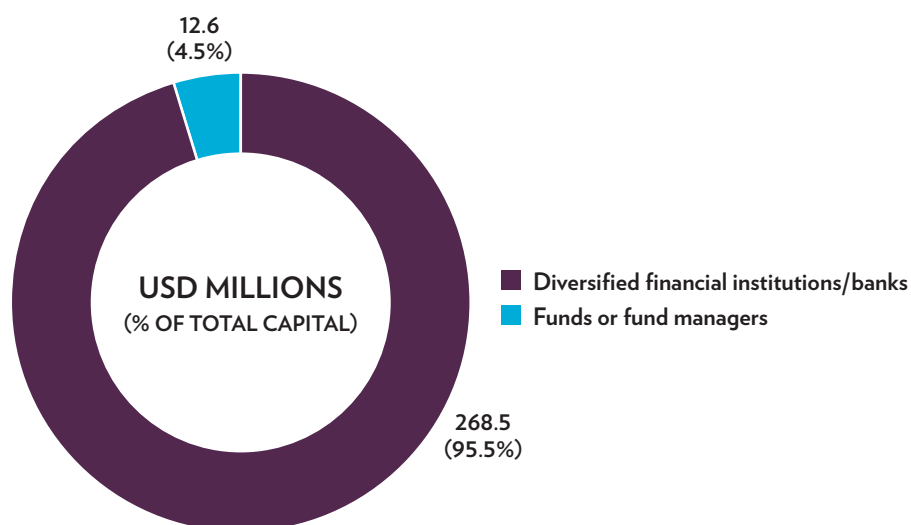
Beyond the impact investing market

The peripheral set of investors (Ring 2) primarily includes commercial banks making SME loans with DFI capital. This capital makes up nearly 96% of investments among impact-related investors (whose activity is related to impact investing but who lack either an explicit impact intention or measurement). The remaining USD 12.6 million has been deployed by funds and fund managers. For commercial bank loans, we see the following trends:

- Debt and guarantees are the only instruments used.
- Sector selection depends on the lender, but most are sector agnostic.
- Growth stage varies, but in order to meet requirements for securing a commercial bank loan, a firm requires operating history; therefore, this capital is most likely absorbed by SMEs that are at growth or mature stage.
- Deal size is small, as SMEs can only absorb limited amounts of capital.

Beyond SME loans, impact-related funds are deploying capital primarily through long-term debt. About USD 12.5 million has been deployed by these investors as long-term debt (more than five years) and about USD 90,000 through equity.

FIGURE 21: IMPACT-RELATED CAPITAL DEPLOYED BY INVESTOR TYPE (USD MILLIONS)



Sources: Stakeholder interviews; Investor websites; Dalberg analysis

Challenges facing impact investors in Sri Lanka

At the entry level, a key challenge faced by fund managers in Sri Lanka is the difficulty in raising a country-specific fund. It is difficult for fund managers to set up country-specific funds because the minimum investment sizes required by DFI/IFIs are quite high (USD 5-10 million), and also must be below a maximum share of the overall fund (often around 20%). Therefore, funds must raise a substantial amount of capital from other investors to secure DFI/IFI capital. However, several fund managers are currently trying to raise country-specific funds, armed with a greater understanding of the market than those who were unsuccessful at their attempts following the end of the civil war. Fund managers and entrepreneurs seeking capital believe that these country-specific funds will be important additions to the landscape since, at present, regional funds for South Asia tend to focus strongly on India and little capital is available for neighboring countries like Sri Lanka. While fundraising for Sri Lanka has proven to be challenging, investors looking to gain exposure through direct investments find Sri Lanka to be one of the easier markets in the region to enter—as reflected in the high levels of direct investment by a range of impact investors.

Key constraints to the growth of the industry include the following:

- Lack of entrepreneurial culture with a low respect for entrepreneurship and a preference for white collar jobs, which makes identification of viable enterprises challenging
- Misalignment between amount of capital demanded by enterprises and investment sizes preferred by investors
- Low level of financial and operational management skills in most enterprises (common across the region) that makes it difficult to convert opportunities into actual investments
- Limited or uncertain exit opportunities given a) the different preferences and incentives of investors and entrepreneurs; and b) the low likelihood of IPOs.

FIGURE 22: KEY CHALLENGES ACROSS THE INVESTMENT LIFECYCLE IN SRI LANKA



Severity of investor challenges, by stage of investment



Key challenges faced by investors and severity of impact

Difficulty in raising country-specific funds	Few enterprises in Sri Lanka for investment—entrepreneurial culture not as vibrant as in other countries; strong preference for professional jobs rather than business	Few SMEs are investment-ready, typically due to weak corporate governance and a shortfall in financial and operational management skills; e.g., SMEs may be keeping double and triple books, or not disclosing accurate records	Enterprises do not want to take capital in USD. Either convince companies or bear the exchange rate risk	Lack of opportunities for follow-up rounds of investments—companies often too small	Difficulty exiting though IPO—no track record yet for impact investors; low liquidity in capital markets
Difficulty in finding local, experienced fund managers			Misalignment between amount of capital demanded by enterprises and targeted by investors		
Difficult to domicile in Sri Lanka—particularly in terms of PE funds	Identifying potential investees largely through networks	Many SMEs are heavily leveraged (i.e., have taken out multiple loans and are in significant debt)	Need to convince good enterprises to take on equity capital—particularly family businesses		Misalignment between investor preference for exit and investee preference—e.g., entrepreneurs afraid of trade sales that might reduce their control
	Some sectors like microfinance reaching saturation				



Sources: Stakeholder interviews; Investor websites; Dalberg analysis

In an effort to improve entrepreneur capacity and investment readiness of businesses, investors in most other countries in the region have taken an increasingly active role in providing technical and managerial support as well as strategic guidance. This has not been a common approach in Sri Lanka, and given the relatively thin ecosystem, this remains a key challenge.

FIGURE 23: INVESTORS PROVIDING NON-FINANCIAL SUPPORT IN ADDITION TO CAPITAL

Key Enterprise-side Gaps Identified by Investors	Severity of Gap	Investor Offering Non-Financial Support	Services Offered
Lack of entrepreneurial culture		<ul style="list-style-type: none"> International Finance Corporation 	<ul style="list-style-type: none"> Advisory team provides TA to clients Web-based SME toolkit
Poor operational/financial management		<ul style="list-style-type: none"> Lankan Angel Network 	<ul style="list-style-type: none"> Provides mentorship and linkages along with some funding to selected entrepreneurs Runs the yearly venture engine competition, a funding competition
Lack of access to information/networks		<p><i>Equity investors take board seats and may provide strategic support, but in Sri Lanka, this tends to not be particularly active or “hands-on”</i></p>	

Sources: Stakeholder interviews; Dalberg analysis

Looking forward

Fund managers are currently trying to raise USD 100 million for investments in Sri Lanka, in addition to capital being raised regionally (some of which will probably be deployed in Sri Lanka). While these funds will not likely have both active impact intent and measurement (and therefore would be in Ring 2 rather than be considered impact investors), their precise mandates and strategies have yet to be defined. Success stories arising from the activities of these funds could play an important signaling effect for the impact investing industry more broadly.

FIGURE 24: COUNTRY-SPECIFIC FUNDS LOOKING TO LAUNCH IN SRI LANKA BY THE END OF 2014¹²

	SIZE	INVESTMENT TARGETS	LPS	RATIONALE/NOTES
Fund 1	TBD; potentially USD 50 million	<ul style="list-style-type: none"> SMEs Sector agnostic Deal size: USD 2–6 million 	<ul style="list-style-type: none"> 3 DFIs 3 domestic institutional investors GP capital 	<ul style="list-style-type: none"> DFIs understand country and risk, wanting to move into smaller deals Prefer smaller fund with good deals for the first fund
Fund 2	Target USD 20–25 million	<ul style="list-style-type: none"> SMEs Sector agnostic Deal size: USD 3–5 million 	Onshore and offshore HNWI	<ul style="list-style-type: none"> See a gap in small-cap investments HNWIs interested as they see strong potential in Sri Lanka
Fund 3	Target USD 75 million	<ul style="list-style-type: none"> SMEs Sector agnostic Deal size: USD >2 million 	Confidential	<ul style="list-style-type: none"> Building track record with small pledge fund before launch Will retain pledge fund for smaller (USD <1 million) deals

98 Note: Funds were yet to be launched at the time of study.

NEEDS AND OPPORTUNITIES: THE DEMAND SIDE

Overview of impact enterprise ecosystem in Sri Lanka

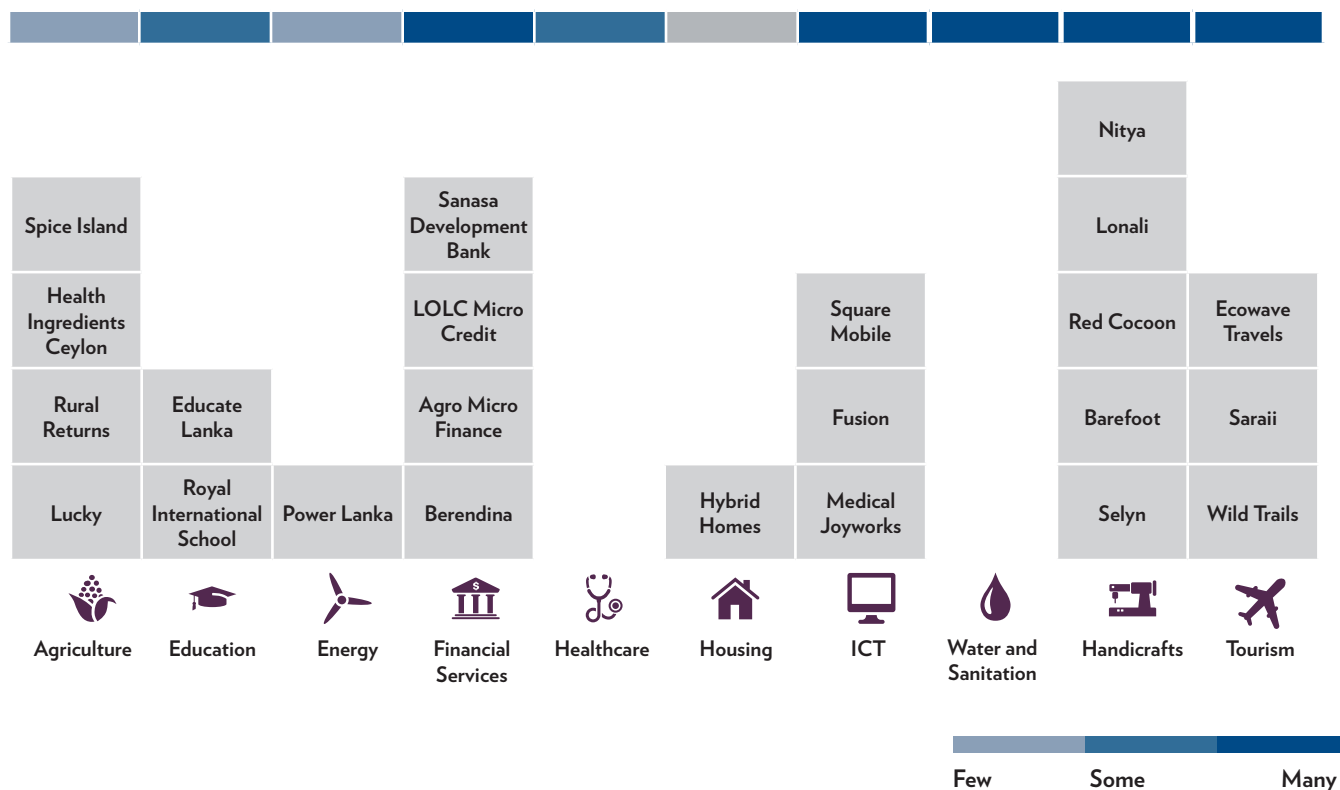
As in other markets in the region, we see only a small share of impact capital deployed into impact enterprises⁹⁹ (outside of the microfinance sector). A few investments have been made by angel investors into impact enterprises, but investors who require larger deal sizes have largely shied away, again with the exception of microfinance investors. In fact, even within the microfinance sector, one enterprise in particular has absorbed a significant share of impact capital—12 investors have collectively invested USD 127 million (26% of the total impact capital in Sri Lanka) into this institution.

Outside of impact enterprises, a large portion of impact capital has flowed into SMEs and, to a lesser extent, enterprises that may not have a clear impact mandate but are operating in sectors that provide basic services. The commercial banks in the peripheral impact-related ring have substantial SME portfolios since this is viewed as profitable and DFIs and IFIs have backed these portfolios. In addition, several new funds currently being established will target SMEs. Impact capital has also flowed into enterprises that provide basic services, such as education and healthcare. However, given the strong government provision of basic services (particularly for the low-income segments of the population), there is minimal need for private intervention in these sectors. As a result, the amount of capital flowing to such enterprises is smaller than the capital being invested in SMEs.

Unlike some of the other regional markets, Sri Lanka has a growing impact enterprise landscape. This growth is driven in part by organizations converting out of traditional NGO models as well as by an increasing recognition and understanding of the impact enterprise approach itself. This growing landscape may result in enterprises that serve as good targets for impact investors in the future as they scale.

⁹⁹ For the purposes of this study, we define impact enterprises as those that have articulated a core objective to generate positive social or environmental impact (as a part of their operating model rather than an ancillary activity) and seek to grow to financial viability and sustainability.

FIGURE 25: ENTERPRISE ACTIVITY BY SECTOR, WITH EXAMPLES



Sources: Stakeholder interviews; Dalberg analysis

As illustrated in Figure 25, impact enterprises to date are heavily concentrated in a handful of sectors: food/agriculture, financial services (predominantly microfinance), handicrafts and fashion, and tourism.

Agriculture is an attractive sector for entrepreneurs as Sri Lanka is still considered an agriculture-based economy and hence, the potential for impact is high. Although the contribution to employment from agriculture is lower than it is from services, many of those employed in the formal sector continue to retain ties to agriculture and return to farms for a portion of the year. As a result, the number of livelihoods affected and the potential to increase incomes are significant. Most models are built around improving supply chains and access to markets, as well as around specialty/niche products.

In the financial services sector, the microfinance model ballooned in the mid-2000s. This could be attributed to the large amounts of capital channeled through MFIs to support recovery and reconstruction after the tsunami. There are currently over 10,000 microfinance branches across the country, though these are not evenly distributed—Northern Province has only 5% of branches, while Southern Province has 24%.¹⁰⁰

¹⁰⁰“Microfinance Sector in Sri Lanka,” South Asia Microfinance Network, <<http://www.samn.eu/index.php?q=mfssrilanka>>.

There is a significant opportunity to leverage traditional skills held by women in various handicrafts (e.g., textiles, cosmetic products, and paper products) to create livelihoods. Entrepreneurs with an impact focus are therefore drawn to the handicrafts sector and are developing varied models that enable women to work from homes/villages or from workshop bases, depending on their preferences. The creation of these locally based workshops is occasionally articulated as an alternative for women who would otherwise migrate to work in garment factories.

Tourism is an extremely attractive and vibrant sector and is attracting heavy investment. For impact-oriented entrepreneurs, Sri Lanka's natural beauty and attractiveness to tourists can be leveraged for social and environmental impact through models that stress environmental protection and responsible sourcing of inputs for hospitality enterprises (such as restaurants sourcing local ingredients to reduce the use of water in growing crops).

There is little enterprise activity in the healthcare and education sectors as the government is a dominant provider of both services. Public provision of these services is widespread, and quality standards are fairly satisfactory, making it difficult for private providers to develop a financially viable offering and model with an impact intention. Enterprises without an impact mandate have developed in the high-end private market, as high prices make businesses very profitable, but the low-cost market remains sparse given the public alternative.

Housing and water are also heavily publically dominated in Sri Lanka and thus, are not attractive for impact investors. New enterprises with some environmental objectives are emerging in the housing market, but these are very small sectors at present.

In Sri Lanka, there is less variation in the theories of change (ToC) of impact enterprises. Incorporation of BoP and/or marginalized populations into the supply chain is a predominant approach, which strongly reflects the concentration of enterprises in the agriculture and handicrafts sectors. Employment creation is not a commonly articulated impact thesis except when framed as livelihood creation for agricultural communities or handicrafts producers.

Two models for launching microfinance organizations have been observed. These models are as follows: 1) institutions founded as NGOs (particularly in the late 1980s and early 1990s, with a second surge after the 2004 tsunami with the availability of grants and subsidized loans); and 2) institutions spun out from commercial banks and finance companies who saw the opportunity in reaching an untapped market and were able to leverage existing capital and experience to align with government priorities and incentives.

For other enterprise sectors/types, we see the following three types of founding entrepreneurs:

- Foreigners/diaspora/Sri Lankan returnees from abroad, who tend to be familiar with the concept of impact-oriented business. Examples include Good Market, Barefoot, and Rural Returns.
- Sri Lankans from business families whose organizations have always operated with combined social impact and commercial objectives but never defined as such or

knew of the term and who are now adopting the language of impact enterprise. Examples include Biofoods, Saraketa, and Selyn.

- Rural entrepreneurs, who have comparatively lower levels of formal education and weaker English skills and who do not independently articulate a social mission, but who are being organized by aggregators/other actors who are working to build retail and processing supply chains.

Older impact enterprises and family businesses tend to be structured as private limited companies, as it is the “traditional” incorporation mechanism and allows profits to be taken out of the company. The newer impact enterprises tend to be structured as guarantee limited companies, as the founders believe the restriction against drawing profits from the company allows a stronger focus on social mission.

Access to finance

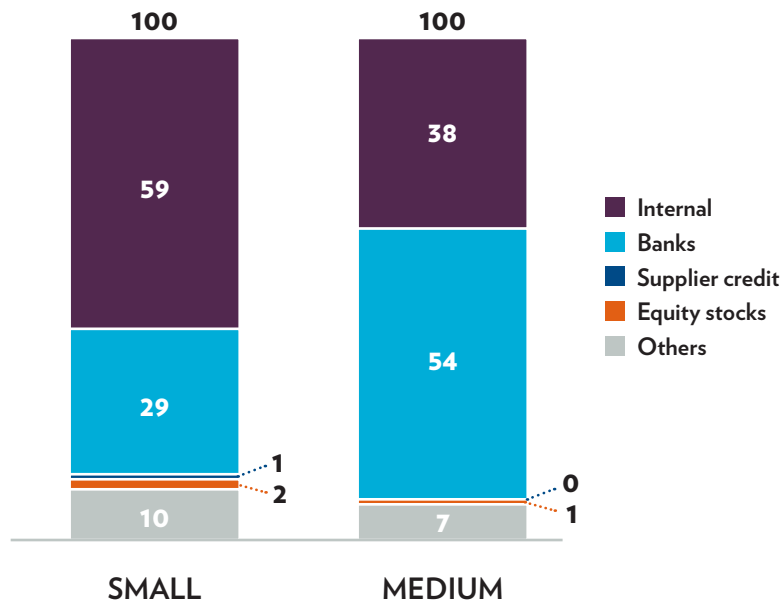
Incorporation status also affects access to capital. Without shareholders, guarantee limited companies cannot take equity and cannot access international debt by law. Therefore, with a lack of local impact capital, it is difficult for these enterprises to access any impact capital.

FIGURE 26: ACCESS TO FINANCE BY ORGANIZATION INCORPORATION STATUS

	INSTRUMENT	GUARANTEE LIMITED	PRIVATE LIMITED
DOMESTIC	Equity	N	Y
	Debt	Y	Y
	Grant	Y	N
FOREIGN	Equity	N	Y
	Debt	N	Y
	Grant	Y	N

Irrespective of the incorporation status, most small enterprises in Sri Lanka (impact enterprises and others) struggle to access institutional capital and hence, are heavily reliant on internal financing. Although internal financing may be sufficient once an enterprise is generating revenue, this financing strategy makes it difficult to reach a stage where an enterprise is generating robust revenue, and constrains the ability to scale over time.

FIGURE 27: PERCENTAGE OF FIRMS ACCESSING DIFFERENT SOURCES OF CAPITAL, BY COMPANY SIZE AND PERSPECTIVES OF ENTERPRISES (PERCENTAGE OF TOTAL RESPONSES, 2011)

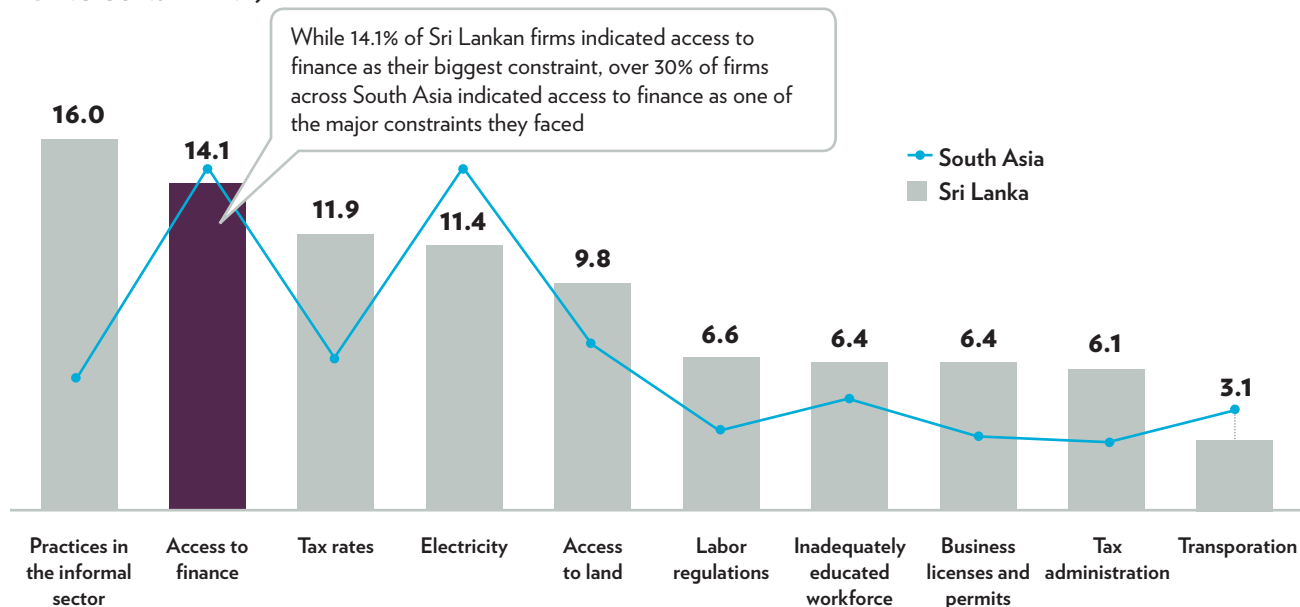


Sources: Enterprise Survey, IFC and World Bank, 2011; Stakeholder interviews; Dalberg analysis

Challenges to enterprise growth

As has already been touched upon, access to finance is one of the top reported constraints to growth by enterprises in Sri Lanka. According to the IFC and World Bank Enterprise Survey, 14.1% of the firms indicated access to finance as their biggest constraint, and over 30% of the firms indicated access to finance as one of the top three constraints that they faced.

FIGURE 28: CONSTRAINTS TO ENTERPRISE GROWTH IN SRI LANKA (PERCENTAGE OF RESPONDENTS CITING AS LEADING CONSTRAINT)



Sources: Enterprise Survey, IFC and World Bank, 2011; Dalberg analysis; Note: 610 enterprises included in the surveys—52% small, 29% medium, and 19% large enterprises; 34% from the Western Province, 19% from the North-Western Province, 11% from the Central Province, the remaining 36% from all other provinces; approximately equal split between five sectors (food, garments, other manufacturing, retail, and services).

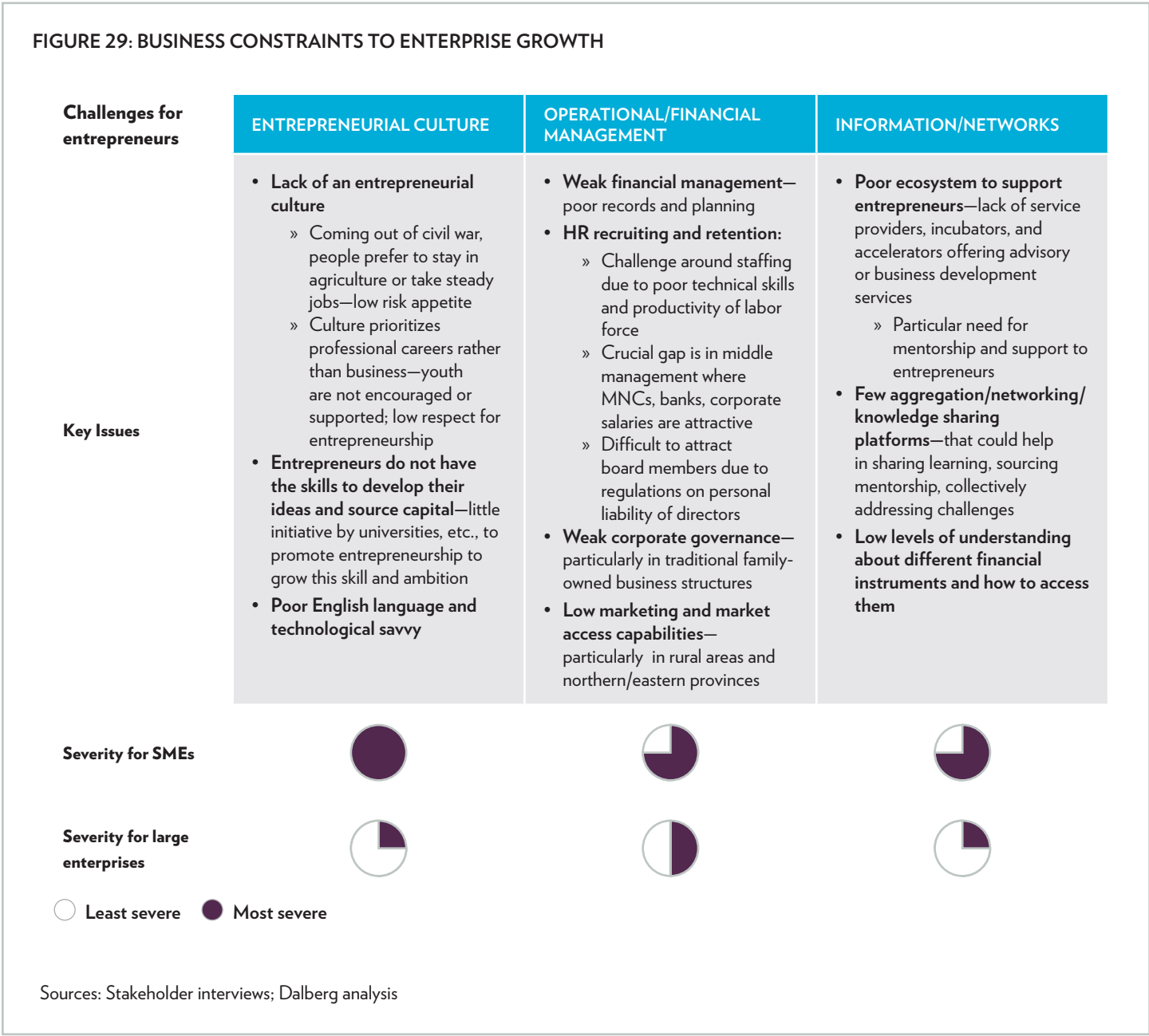
In addition to the challenges reported in the enterprise survey, entrepreneurs, and ecosystem support, actors report three additional constraints:

1. **Entrepreneurial mindset and culture:** Entrepreneurial mindset was particularly emphasized as a challenge unique to Sri Lanka, where there is a strong preference for white collar jobs (e.g., working for banks, government agencies, or multinational corporations) over entrepreneurship or business.
2. **Business skills:** Gaps have been identified in marketing/access to markets and human resources management—both recruiting and retention. In terms of market access, there are at least two main challenges. First, entrepreneurs do not know how to access markets outside their immediate areas and conventional customers (e.g. larger cities or even overseas markets). Second, they typically do not have the capacity to identify and implement solutions to constraints to reaching these markets, such as improved packaging for perishable goods in the agriculture sector.

3. Access to information and networks: There are few aggregators or networking and knowledge-sharing platforms that can help enterprises in sharing, learning, sourcing mentorship, and collectively addressing common challenges.

Interestingly, poor English language and technical skills were highlighted as compounding all the three abovementioned issues. The Government of Sri Lanka’s Sinhala-medium mandate for schools means that English is poorly grasped by many entrepreneurs. This situation limits access to information and the ability to engage with foreign investors. Similarly, poor technical skills make it harder for entrepreneurs to access information and online networks.

FIGURE 29: BUSINESS CONSTRAINTS TO ENTERPRISE GROWTH



In terms of access to finance, not unexpectedly, we see the most severe constraints in the earlier stages of growth. The constraints are particularly severe in the venture stage in Sri Lanka since formal venture capital is scarce and entrepreneurs rely on informal sources for their early capital needs (as in many of the other countries studied).

FIGURE 30: CONSTRAINTS TO ENTERPRISE ACCESS TO FINANCE IN SRI LANKA

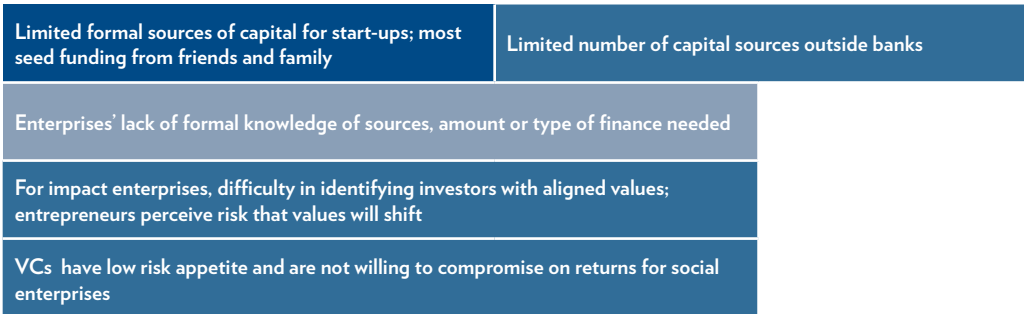


Severity of access to finance challenge, by stage of growth

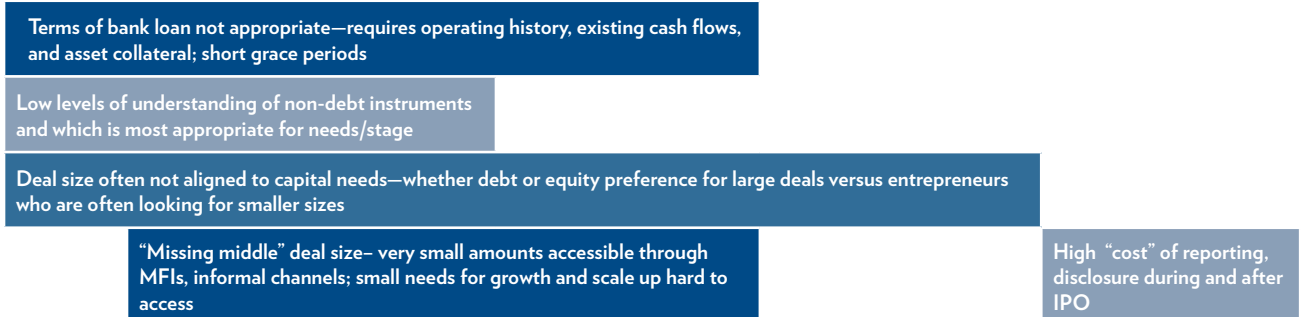


Key challenges faced and severity of impact

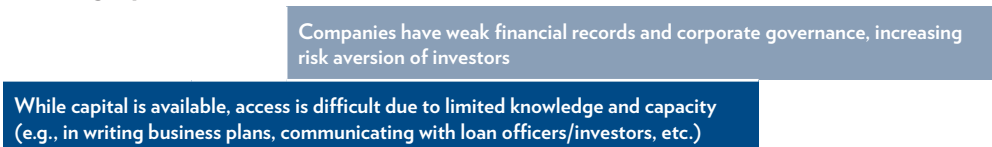
Identifying sources of capital



Appropriateness of capital



Accessing capital



Sources: Stakeholder interviews; Dalberg analysis

Figures 31 and 32 highlight the varied drivers of preference for, and barriers to, accessing different instrument types. As in other markets, entrepreneurs in the early stages have a strong preference for grant funding. However, interestingly in Sri Lanka, there is sufficient understanding of equity and debt for there to be some enterprise interest in equity, unlike in other markets where the instrument is largely unknown.

For growth stage and mature companies, debt is strongly preferred as it enables retention of greatest independence and control. Interestingly, there is a greater wariness of equity capital by leaders of mature companies. Mature companies in Sri Lanka tend to be family businesses that have been successful but that still have a fairly conservative business perspective and are therefore less open to shareholding by equity investors, who they worry will “take over the business.” That said, this perspective is starting to change with the new generation becoming leaders in these companies. In the case of newer impact enterprises that are being established by young returnees, diaspora, and foreigners, we see a greater understanding of and openness to equity capital.

FIGURE 31: SEED AND VENTURE STAGE ENTERPRISES' PREFERENCES FOR CAPITAL

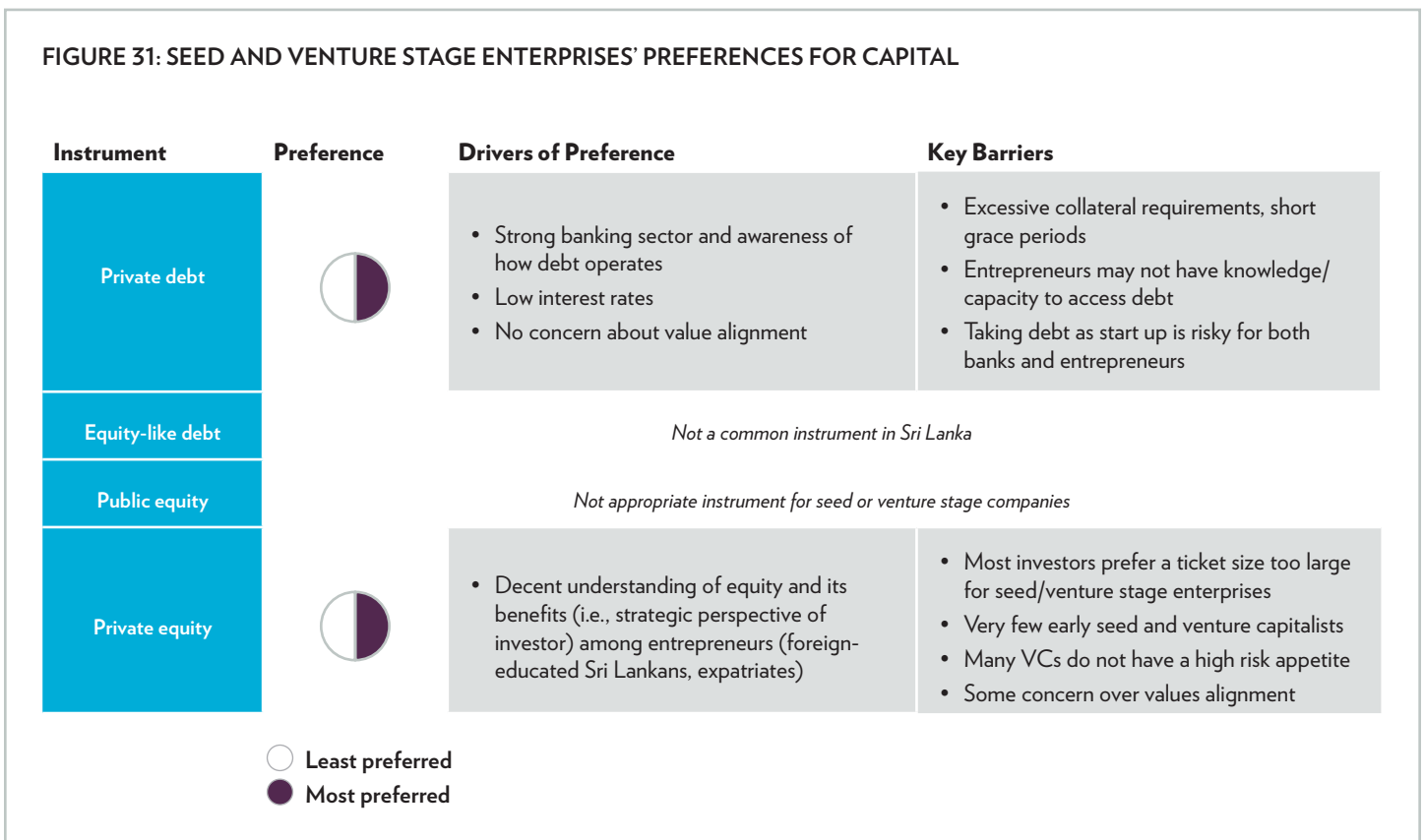
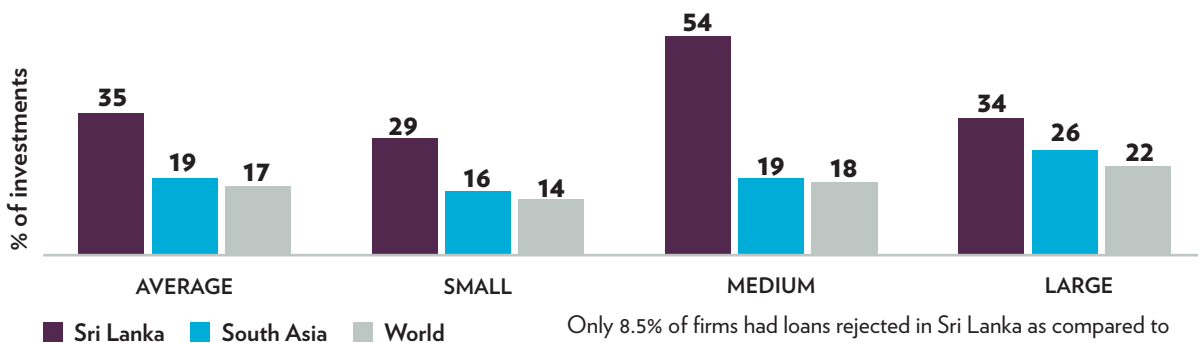


FIGURE 32: GROWTH STAGE AND MATURE ENTERPRISES' PREFERENCES FOR CAPITAL

Instrument	Preference	Drivers of Preference	Key Barriers
Private debt		<ul style="list-style-type: none"> Relatively easy to access—banks comfortable lending to growth and mature companies that have collateral and operating history Strong awareness of how debt operates Low interest rates 	<ul style="list-style-type: none"> High collateral requirements
Equity-like debt		<ul style="list-style-type: none"> Less risky for investors; and they can convert to equity if company does well 	<ul style="list-style-type: none"> Not a common instrument offered by investors Little understanding among enterprises
Public equity		<ul style="list-style-type: none"> Prestige that comes with being a listed company Creates exit option for promoter 	<ul style="list-style-type: none"> Not much liquidity in capital market High volatility in the public equity markets Culturally, companies are built for generations, entrepreneurs unwilling to divest/dilute and often do not want to open the company to public scrutiny
Private equity		<ul style="list-style-type: none"> Increasing understanding of benefits of equity—investors offering additional support 	<ul style="list-style-type: none"> Enterprises reluctant to give up equity in their company—need education and convincing by investors Few private equity investors Ticket size, even in mature companies, is small for many investors (e.g., DFIs)

Despite these constraints, there have been various reports of high rates of over-leverage, particularly in mid-sized to large companies. Highly liquid banks are willing to lend without stringent diligence processes, leading to significant over-borrowing, which makes further investment by equity providers difficult.

FIGURE 33: SHARE OF INVESTMENTS FINANCED BY BANKS/BORROWINGS, BY ENTERPRISE SIZE (2011)



Only 8.5% of firms had loans rejected in Sri Lanka as compared to 16.3% in South Asia and 14.5% globally. Moreover, 0% of medium-size enterprises had loan applications rejected suggesting that access to bank credit less difficult.

Sources: Stakeholder interviews; Indika Hettiarachchi, “Time to reduce borrowings in Sri Lankan enterprises (Data from World Bank/IFC 2011 data),” 2010; Dalberg analysis

ENABLING IMPACT INVESTING: THE ECOSYSTEM

Sri Lanka's government has made strong efforts to create a conducive environment for foreign investment. Sri Lanka's Ease of Doing Business Ranking is much better than that of other countries in the region, with the regional average being 121. Chinese and Indian investors in particular have responded positively and are investing heavily in Sri Lanka.

FIGURE 34: WORLD BANK "DOING BUSINESS" RANKINGS FOR SRI LANKA

	DB 2014 RANK	DB 2013 RANK	CHANGE IN RANK
Overall DB rank	85	83	-2 ↓
Starting a business	54	47	-7 ↓
Dealing with construction permits	108	116	+8 ↑
Getting electricity	91	107	+1 ↑
Registering a property	145	136	-9 ↓
Getting Credit	73	71	-2 ↓
Protecting investors	52	51	-1 ↓
Paying taxes	171	175	+4 ↑
Trading across borders	51	54	+3 ↑
Enforcing contracts	135	136	+1 ↑
Resolving insolvency	59	51	-8 ↓

Change in rank largely due to improvements in other countries

Improved due to process improvements at utility—important especially for manufacturing industries

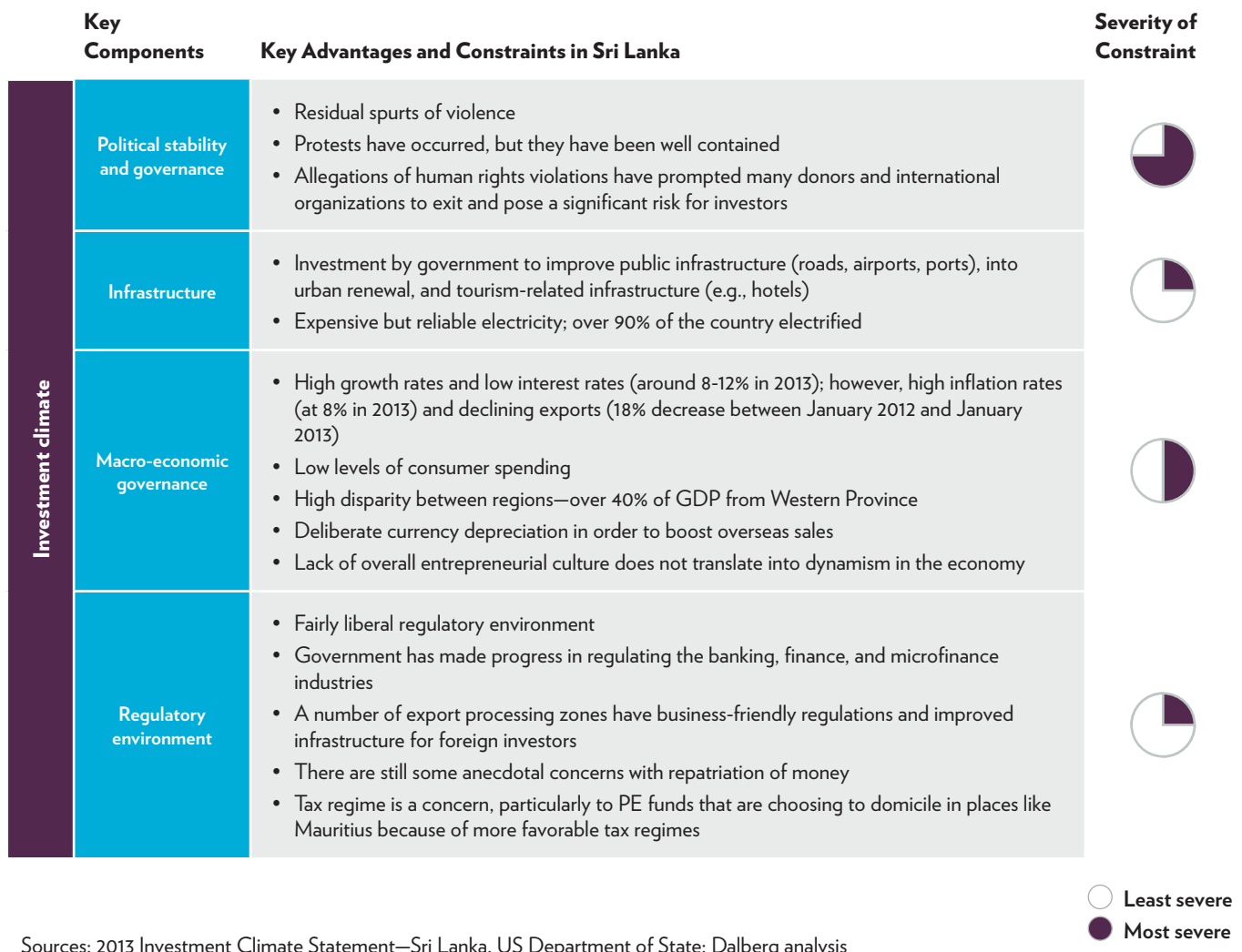
Sri Lanka ranks 52, below Bangladesh, Pakistan, and India

Given the small size of the Sri Lankan domestic market, for enterprises to gain real scale it likely needs to be offshore—ease of cross border trade will be key

Source: World Bank Doing Business Rankings

However, despite this relatively strong performance on key business environment elements, as well as strong infrastructure and conducive regulatory frameworks, other considerations such as uncertainty about security, potential issues in legal protection for investors, and allegations of human rights violations continue to deter some investors.

FIGURE 35: ECOSYSTEM CONSIDERATIONS FOR INVESTORS



Sources: 2013 Investment Climate Statement—Sri Lanka, US Department of State; Dalberg analysis

Beyond the macro considerations, at political and economic levels, key to the successful growth and development of the impact investing industry are the support systems and enablers for investors and enterprises. In general, this landscape is extremely sparse in Sri Lanka. For example, while a few providers of professional services are active in the market, there are few specialized providers of investor support services (e.g., deal sourcing and due diligence). More important, the enterprise support landscape is thin and heavily dominated by the public sector, which is a concern for entrepreneurs who are uncertain of the quality of service given the large mandate on small teams of staff. Further, these services are not accessible to rural entrepreneurs.¹⁰¹

¹⁰¹ “Female entrepreneurship and the role of business development services in promoting small and medium women entrepreneurs in Sri Lanka,” Oxfam, IPS, 2014.

FIGURE 36: STATUS OF INVESTOR AND ENTERPRISE SUPPORT SERVICES IN SRI LANKA

	Key Components	Key Constraints in Sri Lanka	Severity of Constraint
Investment climate	Investor support	<ul style="list-style-type: none"> Generic service providers (e.g., legal, accounting) who can support with registration process exist; however, few specialized investment advisory firms can help with functions such as deal sourcing and due diligence While investors need approval from Board of Investments and Central Bank pre-investment, the process is not considered very difficult (in terms of both requirements and time taken to get approval) Few organizations provide training and support to new fund managers—many locally raised funds are being managed by first-time managers and stakeholders believe the key reason for failed attempts to close previous funds or to build a successful track record was lack of experience 	
	Enterprise support	<ul style="list-style-type: none"> Enterprise development landscape is thin and heavily dominated by the public sector—e.g., few high-quality, private BDS providers (other than some small consulting firms); rather, a wide range of government agencies trying to meet enterprise needs, e.g., National Enterprise Development Authority (NEDA) Government schemes and training exist, however, there are issues of quality and accessibility of these services to rural entrepreneurs A few new aggregators emerging that try to help enterprises access markets—e.g., Good Market and SME.lk Almost no incubators and accelerators that encourage entrepreneurship—the original impetus to entrepreneurship being a key barrier to overcome for the growth of the sector, this gap is important to fill Key areas of need include <ul style="list-style-type: none"> Vocational/skills training institute to create a pool of qualified staff Increase in the number of BDS providers, particularly by private sector to tackle targeted challenges faced by enterprises More incubators/accelerators Efforts to change mindset about working at SMEs 	

Least severe
 Most severe

Sources: “Female entrepreneurship and the role of business development services in promoting small and medium women entrepreneurs in Sri Lanka,” *Oxfam, IPS*, 2014; Dalberg analysis

Considering this enterprise development landscape, overall, there are very few players active in the market. Interestingly, in recognition of this gap, some domestic microfinance banks are now starting to provide business planning and financial record keeping training to support entrepreneurs (at a subsidized rate). Commercial banks are increasingly interested in providing a similar service to their clients.

FIGURE 37: LANDSCAPE OF ENTERPRISE DEVELOPMENT SUPPORT IN SRI LANKA

Incubators/Accelerators



Advisory Services



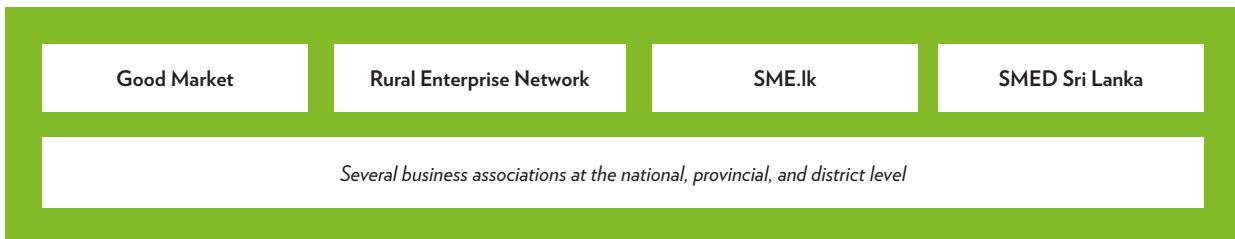
Credit Rating Services



TA Providers



Aggregators



AREAS FOR FURTHER RESEARCH

In order to deepen the understanding of the impact investing market in Sri Lanka, we believe there is a need for further research in at least three specific areas. First, as in other countries, the role of the diaspora in the entrepreneur and investor community in Sri Lanka is worth further study. While it is evident that, currently, the most mature entrepreneurs are those who have returned to the country from abroad, it would be interesting to develop a more nuanced understanding of the effect of this diaspora on both the supply and demand aspects of impact capital.

Second, with a growing yet sizeable market in comparison to population size, further exploration of the fund economics for country-specific funds would be valuable. For example, for a market with a small population and currently limited entrepreneurial culture, a deeper understanding around the saturation point, turnover, and life cycle of a Sri Lanka-focused fund would support an understanding of the domestic challenges and opportunities.

Finally, our current understanding is that the support system for enterprises in Sri Lanka is yet to fulfill the needs—there are very few incubators or accelerators that provide advisory support services. Not only this, but perhaps a more deliberate, innovative engagement with potential and early stage entrepreneurs (such as business plan competitions or other catalytic activity), would encourage the entrepreneurial spirit in Sri Lanka. A more focused assessment of the feasible options within the local context could help shape the ecosystem for investors and investees in the future.

MYANMAR



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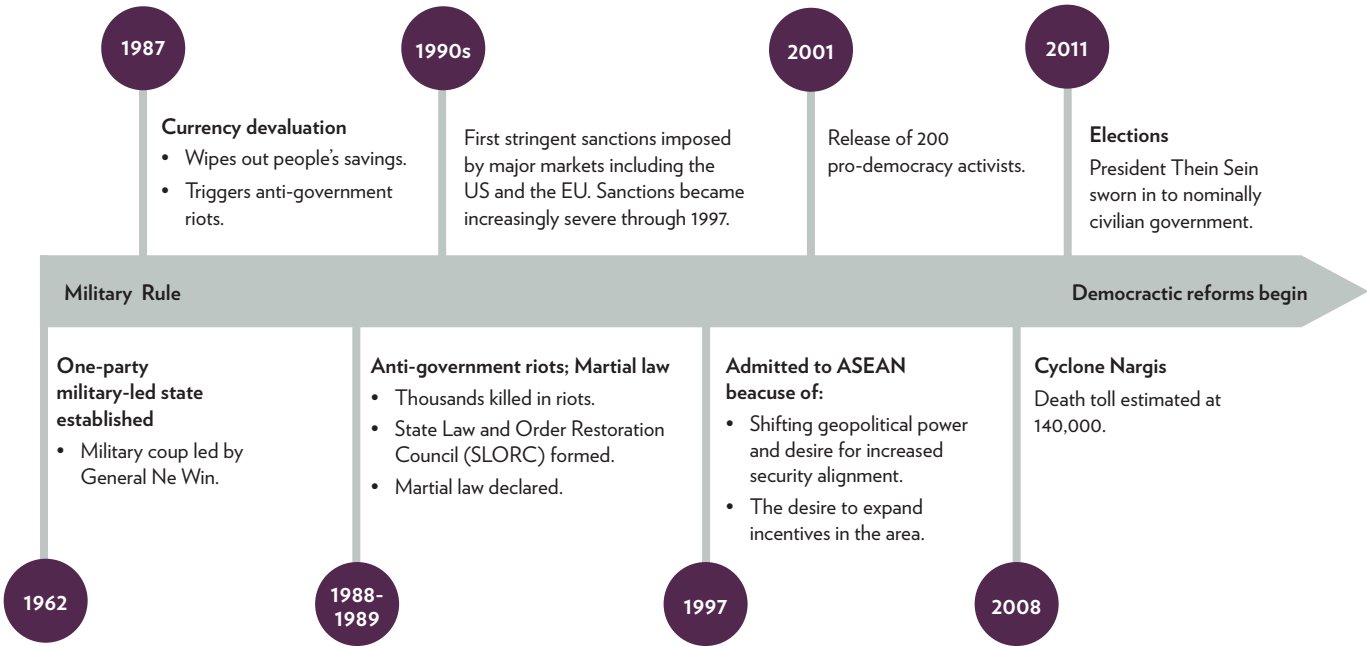
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COUNTRY CONTEXT

Overview

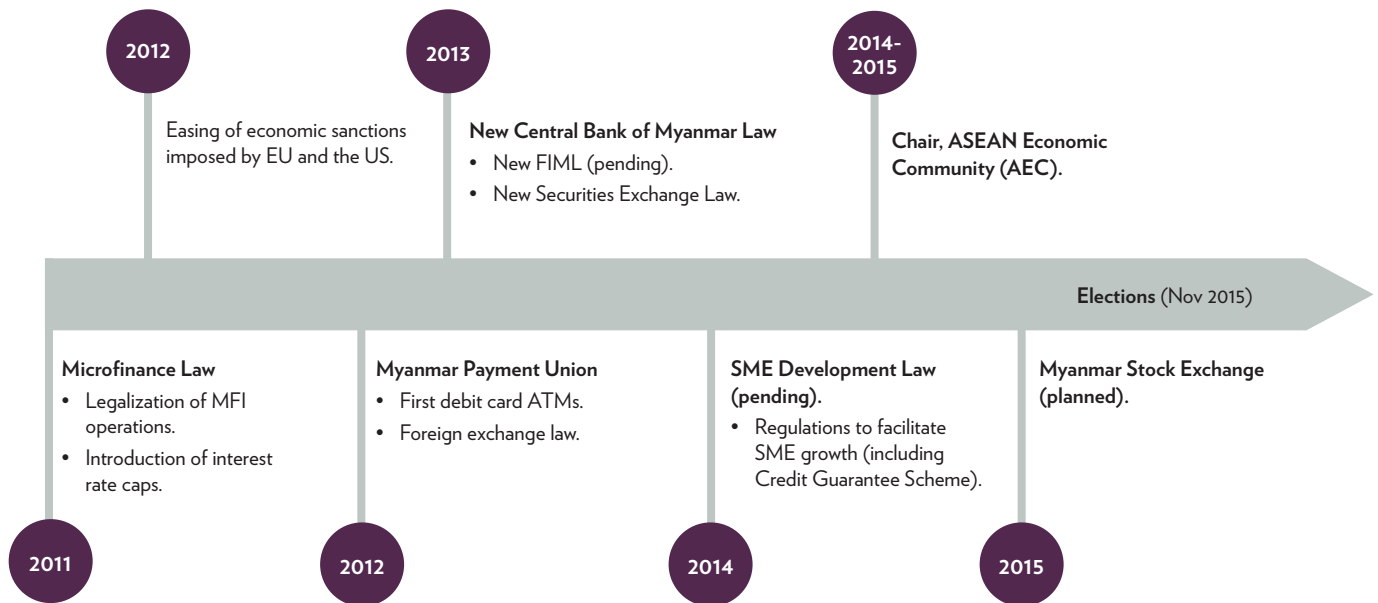
In the early 1960s, Myanmar was one of Asia’s leading economies, with a per capita income of approximately USD 670, more than three times that of Indonesia and twice that of Thailand. However, the military coup in 1962 that launched the “Burmese Way of Socialism” and nationalized all non-agricultural enterprises contributed to a dramatic shrinking of the economy. By 2010, according to International Monetary Fund (IMF) estimates, Myanmar had the lowest GDP per capita in purchasing power parity in Asia. Strict sanctions imposed by the United States, Canada, the European Union, and others after the imposition of martial law in 1988 were eased only in 2011, following democratic reforms and the election of President Thein Sein.

FIGURE 1: TIMELINE OF KEY EVENTS IN MYANMAR'S POLITICAL HISTORY



Sources: Dalberg research and analysis.

FIGURE 2: TIMELINE OF KEY LEGAL AND ECONOMIC REFORMS UNDERTAKEN IN MYANMAR SINCE 2011



Sources: GIZ Banking Sector analysis, Dalberg research and analysis. Notes: New bank law provides the new Central Bank autonomous power to implement monetary and exchange rate policies. New securities law includes the ability to establish a stock exchange, securities exchange companies, and counter markets.

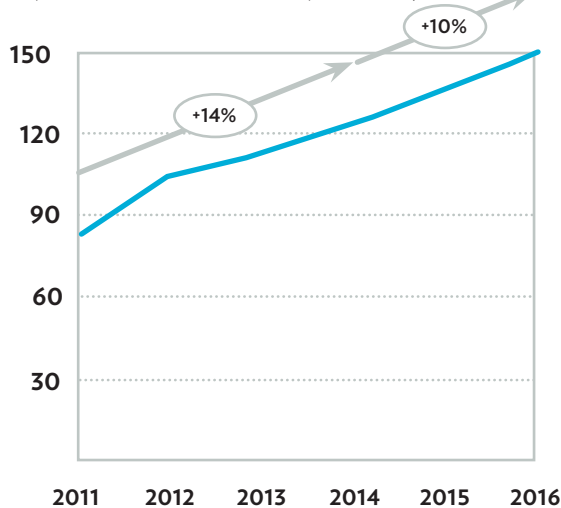
GDP growth and drivers of foreign direct investment (FDI)

Since 2012, Myanmar has experienced rapid GDP growth. From a purchasing power parity (PPP)-adjusted GDP of USD 82.6 billion in 2011, Myanmar's PPP-adjusted GDP grew to USD 95.4 billion in 2013.¹⁰² Moreover, Myanmar is forecasted to grow annually at a rate of 10% between 2014 and 2016, outperforming regional neighbors including India.¹⁰³ It should be noted that since Myanmar has only recently opened its economy and begun democratic reforms, the task of sourcing high-quality macroeconomic data is more difficult than in other countries. However, the following sections rely on the most reputable sources available, such as the World Bank and IMF.

FIGURE 3: HISTORIC AND FORECASTED GDP IN MYANMAR; GROWTH FORECAST VERSUS REGIONAL PEERS

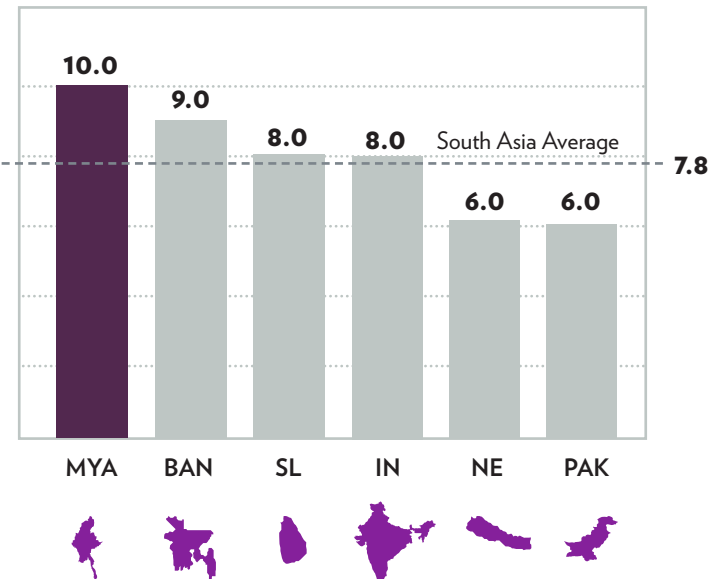
GDP OF MYANMAR

(PPP, INTERNATIONAL DOLLAR, BILLIONS)



FORECASTED GDP GROWTH RATE

(% P.A., 2014 TO 2016)



Sources: World Bank Development Indicators; International Monetary Fund database, Dalberg analysis

Recent GDP growth has been driven by a significant shift from agriculture towards industry and services.

Moreover, within the services sector, travel and tourism have significantly contributed to growth with a recorded 79% increase in their direct contribution to GDP between 2010 and 2013 (Figure 4).

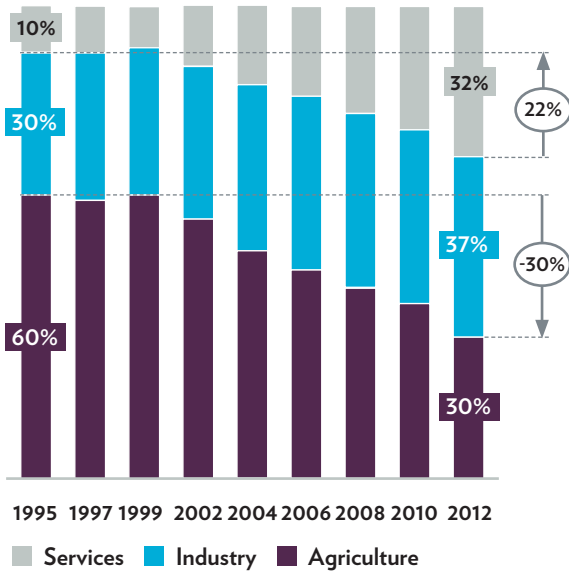
¹⁰² International Monetary Fund (2014). *World Economic Outlook Database*, April 2014.

¹⁰³ It is important to note that the data collection, monitoring, and forecasting capacity of the relatively new bureaucracy is still low. Therefore, it is challenging to make confident assessments of the real state of the economy.

FIGURE 4: MYANMAR'S GDP GROWTH: BY SECTOR AND IN TRAVEL AND TOURISM CONTRIBUTION TO GDP OVER TIME

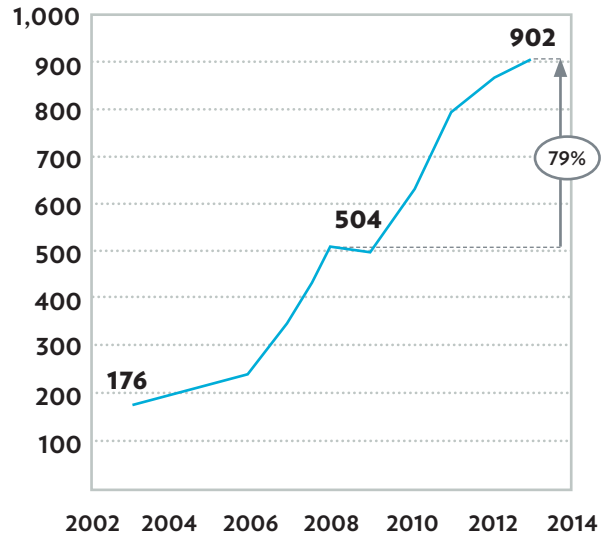
GDP GROWTH RATE BY SECTOR

(VALUE ADDED % OF GDP)



TRAVEL AND TOURISM DIRECT CONTRIBUTION TO GDP

(USD MILLION, % REAL GDP GROWTH)

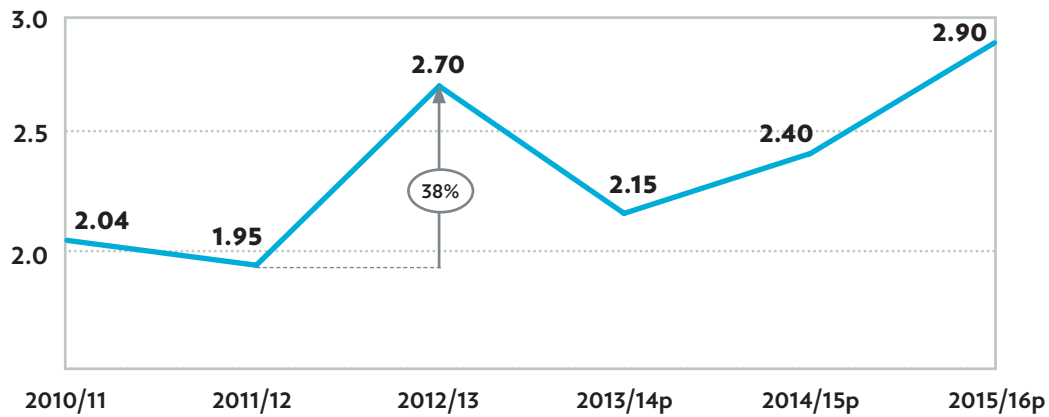


Sources: World Travel and Tourism Council (2013); ADB online data (2014)

In addition to strong GDP growth, the following three key elements are attracting commercial investors to Myanmar:

- Natural resource endowments:** Myanmar has significant reserves of natural gas (currently a crucial source of export revenue), oil (with 2.1 billion barrels of known reserves and offshore wells largely unexplored), and precious stones such as ruby and jade (according to industry estimates, Myanmar accounts for more than 90% of the global trade of precious stones by value).
- Large market and labor force:** With a total population of 60 million, a median age of 27 years, and a nearly 93% literacy rate, Myanmar is an attractive destination for investors from the perspective of both labor force and consumer market. The labor force makes sectors such as light manufacturing particularly promising. Meanwhile, rapid urbanization is expected to create a strong consumer market, particularly among the urban upper-middle class.
- Geo-strategic location:** Bordering China, Thailand, India, Laos, and Bangladesh and with control of access to the Bay of Bengal, Myanmar has strong trade and business potential and strong influence in the region, which could further leverage regional networks and bi-lateral relationships.

FIGURE 5: FOREIGN DIRECT INVESTMENT IN MYANMAR, ACTUAL AND PROJECTED (USD BILLIONS)



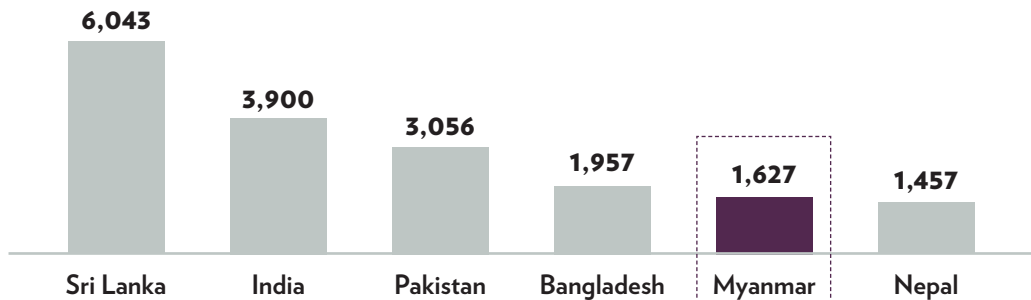
Sources: World Travel and Tourism Council (2013); ADB online data (2014)

As a result, there is strong investor interest in Myanmar, reflected in steady growth in FDI inflow since 2012, projected to reach over USD 2.9 billion by 2016.

Notably, while over 85% of FDI between 2005 and 2013 was in gas, oil, mining, and power,¹⁰⁴ data for 2013 and 2014 show a different trend, with a strong movement out of the extractive sectors and into manufacturing and tourism. In addition, the telecom sector is expected to attract USD 1 billion in 2014.¹⁰⁵

Despite recent FDI inflows and steady economic growth, Myanmar’s per capita income is still among the lowest in the region. With such low GDP (PPP) per capita (see Figure 6), Myanmar’s significantly large BoP population creates both a need and an opportunity for enterprise innovation in the development and delivery of basic products and services, as well as a need and an opportunity for investment to support this enterprise development.

FIGURE 6: COMPARATIVE GDP, PURCHASING POWER PARITY (PPP) PER CAPITA, 2012 (CURRENT INTERNATIONAL DOLLARS)



Source: IMF (2012)

¹⁰⁴“OECD investment policy reviews: Myanmar,” OECD, 2014.

¹⁰⁵International Business Times, March 2014.

Key constraints in Myanmar

Myanmar is one of the more challenging countries in which to start and run a business. Because of its long period of military dictatorship and extended isolation, and despite momentum towards reform, Myanmar remains the most challenging country in the world in which to start a business, and the seventh most challenging in which to do business.¹⁰⁶ Key constraints include the regulatory environment, weak infrastructure, and a hugely underdeveloped financial sector. As will be discussed later in this report, regulatory constraints include complex and opaque screening and investment approval mechanisms, foreign equity restrictions, and complicated separate laws governing foreign and domestic investment.¹⁰⁷

The new government that took over in 2011 has been actively working with development agencies such as the Asian Development Bank (ADB), the International Finance Corporation (IFC), and the Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) to ease these constraints; however, the environment remains challenging.

The government has been implementing legal, policy, and economic reforms to increase the attractiveness of Myanmar to investors. For example, the new Foreign Investment Law (FIL), introduced in 2012, repealed the 1988 FIL and provides a more open and secure legal environment for investment. While a positive step and signal, the report of the UN's Special Rapporteur¹⁰⁸ in 2012 expressed concern that the government's haste to provide a new legislative framework may be at the expense of credible, suitable laws that are implementable given existing government capacity.¹⁰⁹

In terms of infrastructure, Myanmar's electricity supply is limited and unreliable. As of 2011, less than half of Myanmar's population has access to electricity. Of the total installed power generation capacity, only 50% is reliable because of the fact that weather-dependent hydropower plants account for 75% of total electricity generation. This weak power infrastructure makes it challenging to grow the industrial base and limits investor interest. In 2011, the energy consumption in Myanmar stood at 110 kilowatt hour (kWh) per person, which was the second lowest among the other countries of study (ranging from 106 kWh per person in Nepal to 685 kWh per person in India).

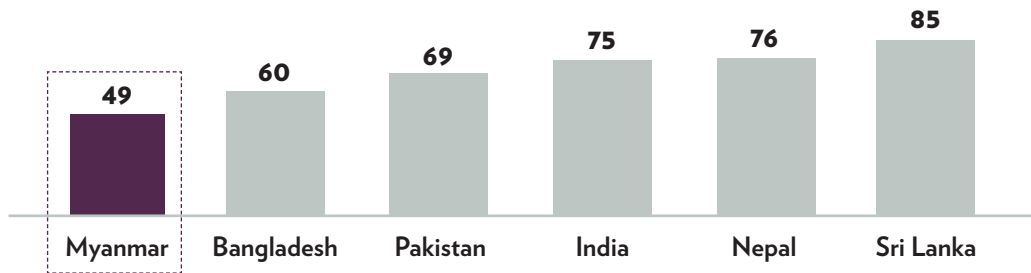
¹⁰⁶ World Bank "Doing Business" rankings, 2014. These rankings include ease of getting electricity, registering property, obtaining construction permits, paying taxes, and enforcing contracts. The World Bank "starting a business" rankings include indicators such as length of time and number of procedures to complete for registration/start-up, as well as the associated costs of start-up procedures.

¹⁰⁷ OECD's 2013 FDI regulatory restrictiveness index seeks to gauge the restrictiveness of a country's FDI rules and market access restrictions—a critical determinant of a country's attractiveness to foreign investors.

¹⁰⁸ The UN Special Rapporteur reported in 2012 that "there remains no clear and comprehensive strategy for legislative reform, resulting in a somewhat ad hoc and uncoordinated process." OECD, 2014.

¹⁰⁹ "OECD investment policy reviews: Myanmar," OECD, 2014.

FIGURE 7: COMPARATIVE ACCESS TO ELECTRICITY (2011, % OF POPULATION)



Sources: World Development Indicators, The World Bank

Other key infrastructure, such as information and communication technology (ICT) and telecommunications, is also currently limited (Figure 8), but is expected to vastly improve in the next few years. Telecommunication giants Telenor and Ooredoo won licenses in 2013 to launch a communications network in Myanmar, with the goal to grow mobile penetration to 80% by 2016.

In addition to weak infrastructure, economic isolation has severely constrained the development of the formal finance sector. Only 4% of Myanmar's adult population has an account at a formal financial institution (Figure 9). Individuals have relied on informal practices (e.g., cash safes, gold savings, personal networks, and money lenders), and Burmese migrants have largely used hundi operators¹¹⁰ to undertake transfers into Myanmar. As a result,

- Formal savings are low, which hinders the stability of investments made from domestic banks.
- Financial literacy and trust are low. Thus, entrepreneurs have low capacity to work with investors' requirements and processes, and are wary of investment.

Moreover, Myanmar has a very small and nascent banking infrastructure.

Myanmar's banking industry is dominated by four state-run and 22 domestic private banks. Foreign banks are currently not allowed to fully operate in Myanmar; their banking presence is relegated to in-country local representation. According to recent 2014 regulations, a select number of foreign bank branches will be able to provide loans to foreign corporations in Myanmar; however, this is currently under development and is likely to be tightly regulated.¹¹¹

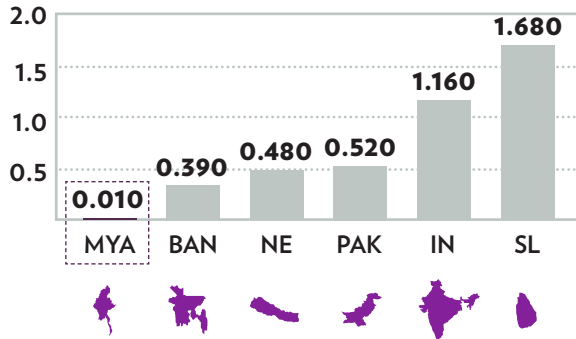
¹¹⁰ The hundi is an informal cash transfer system consisting of a combination of agents and middlemen along a word-of-mouth chain from a sender abroad to a recipient in Myanmar.

¹¹¹ Ferrie, J., "Burma to grant foreign banks licenses by end of September," Reuters, May 2014.

FIGURE 8: COMPARATIVE INFRASTRUCTURE PROVISION IN ICT AND TRANSPORT

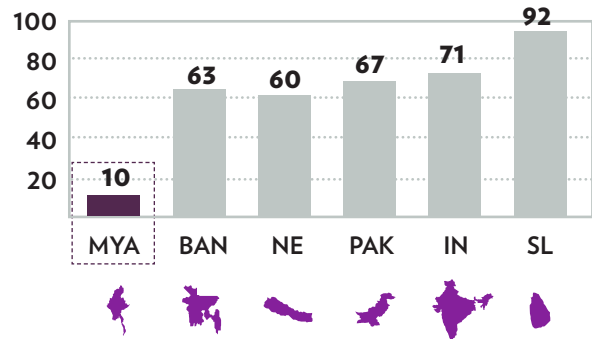
FIXED BROADBAND AND INTERNET SUBSCRIBERS

(PER 100 PEOPLE, 2012)



MOBILE CELLULAR SUBSCRIPTIONS

(PER 100 PEOPLE, 2012)

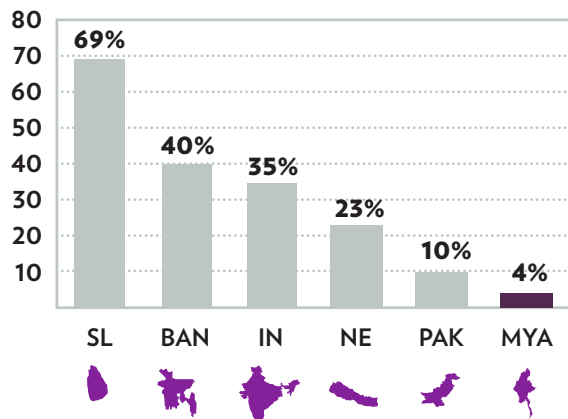


Source: World Development Indicators, The World Bank

FIGURE 9: ACCESS TO FINANCIAL SERVICES AND BANKING INFRASTRUCTURE IN MYANMAR

PERCENTAGE OF ADULT POPULATION (AGE 15 AND ABOVE) WITH ACCOUNTS AT A FORMAL FINANCIAL INSTITUTION

(2011 DATA; 2014 FOR MYANMAR)



REGISTERED/FORMAL FINANCIAL SERVICES

(MYANMAR, 2014)

TYPE	# OF BANKS	OVERVIEW
Government banks	4	Includes MEB, MICB, MFTB, and Myanmar Agriculture Development Bank (MADB), which provides MFI loans to farmers
Private banks	22	10 are fully private and nine are quasi-state or "semi-private" banks
Representative offices of foreign banks	19	Foreign banks are not allowed to operate in Myanmar; however, foreign banks have established local representation offices in-country

Sources: Global Findex; World Bank; UN MAP Project (May 2014, Myanmar Data); PwC Myanmar Business Guide, 2014. Note: Myanmar Economic Bank (MEB); Myanmar Foreign Trade Bank (MFTB); Myanmar Investment and Commercial Bank (MICB)

Nevertheless, as demonstrated by GDP growth and FDI inflows, the difficult investment climate has not been a deterrent to all investors. Despite significant regulatory and infrastructural constraints, and a limited formal financial services system, investors are actively scoping investment and deploying capital into Myanmar.

INVESTING IN MYANMAR: THE SUPPLY SIDE

The broad impact capital market in Myanmar

Despite the nascent economy and restrictive regulations, there is strong investor interest in Myanmar; some investors have actually deployed capital, and most are still raising funds or developing pipelines. To date, approximately USD 12 million

has been deployed by impact investors in Myanmar, of which USD 8 million has been deployed by DFIs. A further USD 44 million has been deployed by impact-related investors. DFIs (development finance institutions) and IFIs (international finance institutions) as the “first movers”¹¹² play a significant role, having deployed over USD 40 million in both direct and indirect investments into microfinance and real estate.¹¹³ However, we will only be taking a deeper look at direct investments made by DFIs in this report to avoid potential double-counting of impact capital. In contrast, angel investors and funds have deployed around USD 9 million to smaller ticket-size investments towards seed, venture-stage, and mature enterprises in a variety of sectors, including energy, information and communication technology (ICT), financial inclusion, and rural infrastructure. Further, fund managers and DFIs have raised or committed more than USD 119 million for future deployment. Moreover, fund managers are targeting to raise a minimum of an additional USD 180 million for deployment in Myanmar in the next two to five years.

While there is significant excitement on the part of investors to enter Myanmar, they are hesitant to invest prior to the establishment of more favorable investor regulations. Many investors are adopting a “wait-and-see” approach to investing until after the November 2015 elections for greater clarity on their political and regulatory impact. However, despite political uncertainty and current regulatory constraints, investors are encouraged by the continued movement of new regulatory reforms passed in the past year.¹¹⁴

112 A majority of DFIs and IFIs restarted their activities and investments around 2012, when the US and European sanctions had been relaxed and/or lifted.

113 For the purpose of this analysis, a large DFI investment into an infrastructure fund, which has deployed the entire portfolio amount, is classified as a direct investment from the fund manager.

114 GIIN/Myanmar expert panel discussion, July 2014.

Active investors deploying impact capital in Myanmar

There is a range of investor types active and interested in deploying capital into Myanmar, including funds, development finance institutions (DFIs), angel and institutional investors, foundations, and high net-worth individuals (HNWIs).

While investment activity in Myanmar is currently in its very early stages, we have seen deployments by close to ten investors (of which four are impact investors), albeit in small amounts. However, there are strong efforts underway towards raising additional capital and building pipelines for deployment. The low levels of current fund activity are due in part to the sparse landscape of investment-ready enterprises—and the intensive support required to help enterprises become investment ready—and in part to the early stage of the broader market (Figure 10).

Currently, diversified financial institutions (including banks) have fairly low levels of activity with respect to making impact or impact-related investments.

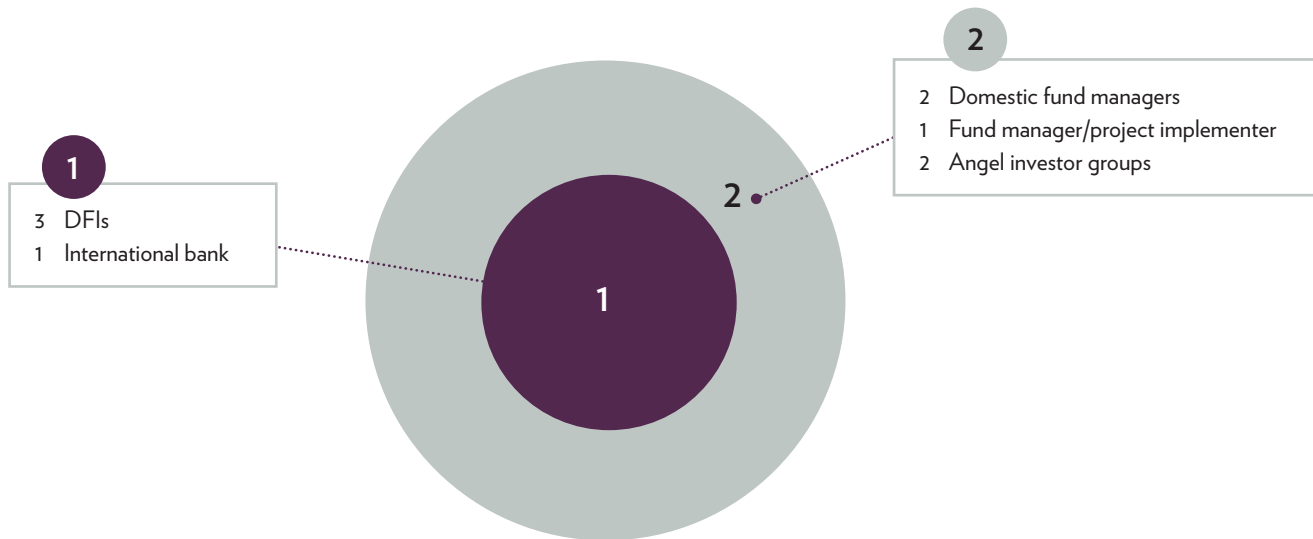
However, we are starting to see international banks exploring opportunities to invest in financial inclusion, particularly by investing in microfinance institutions (MFIs). In addition, a few state-run banks (such as the Myanmar Agricultural Development Bank and the Small and Medium Industrial Development Bank) have increasingly started lending to small and medium enterprises (SMEs) with specialized loan products. However, private commercial banks have not developed tailored products for SMEs as the regulations set by the Central Bank around terms like collateral requirements and repayment periods make the segment highly risky and not financially attractive. Regulations also inhibit entry by foreign banks as they cannot yet be licensed for banking operations in Myanmar. Still, select banks such as Standard Chartered and Yoma Bank (which has a focus on sustainability) are scoping the market and exploring opportunities to increase SME lending in key impact sectors in the future.

Foundations and HNWIs are also active in Myanmar, but they largely engage through the provision of grants rather than instruments for which there is a return expectation. Established foundations such as the Skoll Foundation, the Mulago Foundation, and the Schwab Foundation for Social Entrepreneurship have already provided grant-based funding to social enterprises in Myanmar and, by doing so, are attempting to send a signal to other investors about the potential viability of the impact investing market in Myanmar. In addition to the international foundations mentioned above, there is increased activity from domestic foundations, corporate foundations, and the corporate social responsibility (CSR) divisions of large businesses (such as City Mart, Myanmar's leading supermarket chain). In fact, CSR activity and donations to social impact sectors and enterprises are likely to increase as multi-national corporations (MNCs) start to enter Myanmar and seek to build strong brands.¹¹⁵ Some companies may invest on a capital-recovery-only basis and/or more broadly support the SME ecosystem through training grants or other means.

¹¹⁵ Examples of MNCs undertaking CSR activity across sectors include Coca-Cola providing a USD 3 million grant to the Pact Global Microfinance Fund to create women-based community banks that fund start-ups, Hewlett Packard's support/training to SMEs, Procter & Gamble's focus on clean water projects, and Ooredoo's plan to provide targeted training in information technology and human resources.

As in other markets, HNWI are a significant source of informal, donated start-up capital for many enterprises in Myanmar, typically accessed through personal networks (and difficult to access without these networks). Another nascent source of seed funding for impact enterprises is angel investors. There is a small but emerging angel investment landscape, with at least two angel foreign investment networks (based in Asia) deploying small ticket-sized equity investments to seed and venture-stage impact enterprises.

FIGURE 10: DIRECT IMPACT AND IMPACT-RELATED INVESTORS ACTIVE IN MYANMAR (DEPLOYED CAPITAL)¹⁷



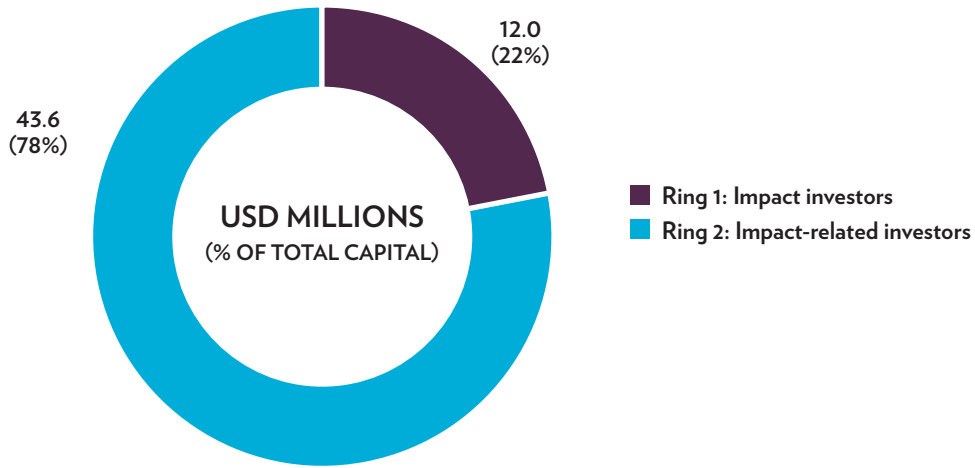
Sources: Stakeholder interviews; Investor websites; Dalberg analysis

The following analysis should be viewed as reflective of the early stage of the impact investing market in Myanmar but not necessarily as indicative of trends going forward. As only a few impact investors are currently active in the market, capital deployment and analysis of key variables to follow reflect the activities of only four current impact investors and five future impact investors.

Overall, only a small portion of capital has been deployed to date. Approximately USD 12 million has been currently deployed by impact investors, and a total of approximately USD 43.6 million by impact-related investors (Figure 11), who have a less explicit impact intention but still consider impact as an element or outcome of their investment.

¹¹⁶ See “Defining key terms and concepts” in the introduction chapter of this report for an explanation of the framework used for categorizing investors using a two-ring framework, where the inner ring—Ring 1—represents the impact investing activity and the outer ring—Ring 2—represents the activity related to impact investing but lacking either an explicit impact intention or measurement.

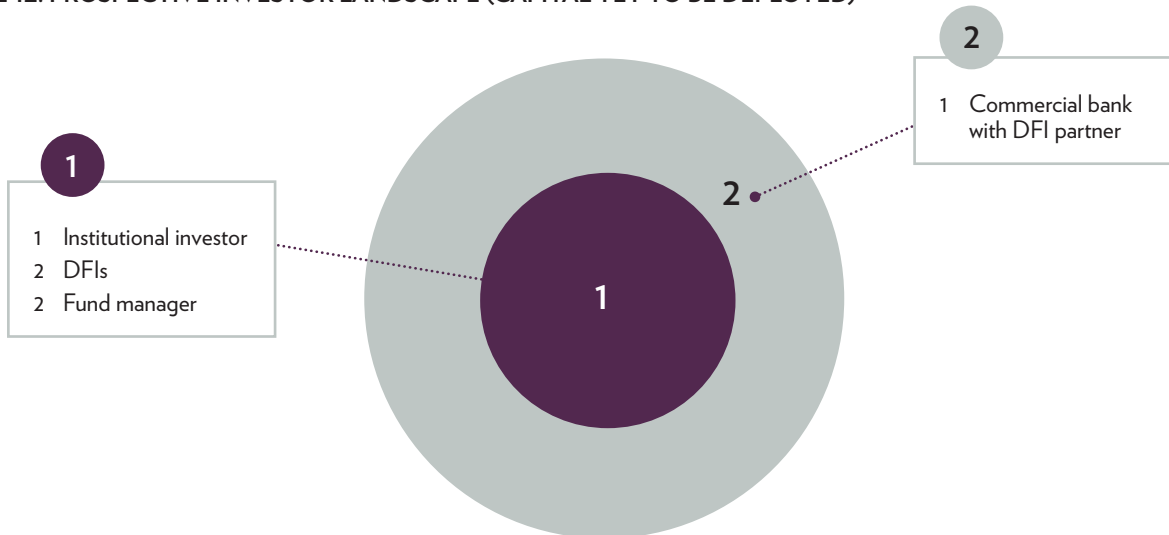
FIGURE 11: TOTAL CURRENT CAPITAL DEPLOYED BY RING



Source: Stakeholder interviews; Investor websites; Dalberg analysis

Two DFIs, two fund managers, one institutional investor, and one commercial bank with DFI backing have all committed to deploy capital in Myanmar. Given the limited amount of risk capital in Myanmar overall, at least three commercial private equity (PE) funds are also being raised by domestic fund managers. Figure 12 maps the stakeholders who have committed capital for deployment in Myanmar in the future.

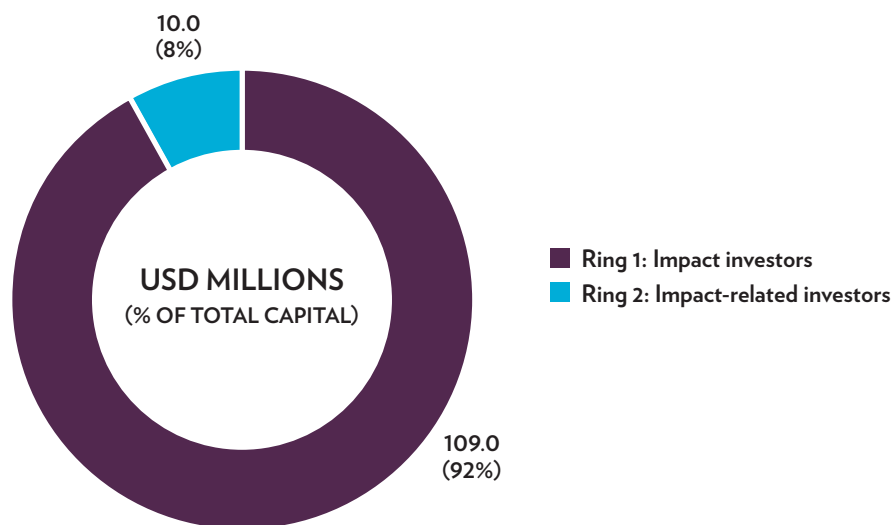
FIGURE 12: PROSPECTIVE INVESTOR LANDSCAPE (CAPITAL YET TO BE DEPLOYED)



Sources: Stakeholder interviews; Investor websites; Dalberg analysis

Approximately USD 109 million has been committed or raised by impact investors for direct investment into enterprises in the future (Figure 13). In addition, several investors are actively raising funds and are expected to commit a minimum of an additional USD 180 million in the next two to five years. This is, in part, due to investors awaiting upcoming regulatory changes and elections (November 2015) and due to some investors being wary of engaging while current ethnic conflict in some parts of the country is still active. This category of committed and raised capital includes disbursements that are still pending but likely to be deployed, and capital earmarked to be deployed into Myanmar in the next one to two years.

FIGURE 13: FUTURE COMMITTED CAPITAL BY RING



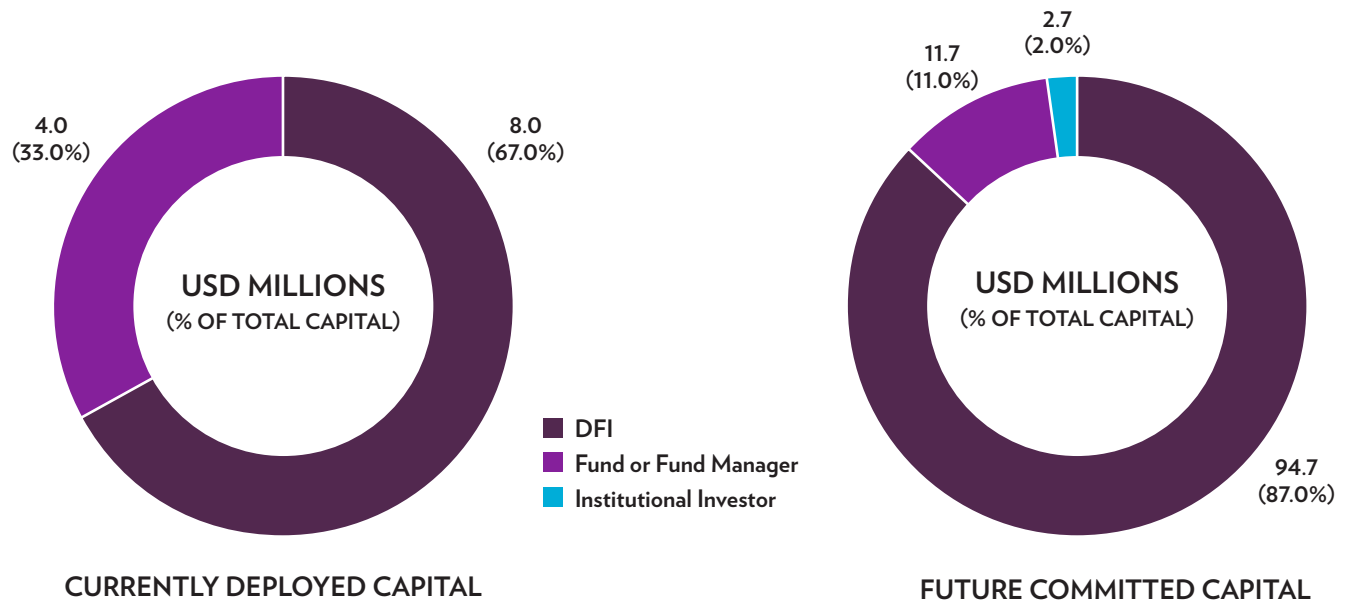
Source: Stakeholder interviews; Investor websites; Dalberg analysis

These direct investments, including USD 109 million by impact investors, include DFI investments allocated to financial services and real-estate development; other investors include institutional investors and PE funds targeting high-growth SMEs and large-scale MFIs. Unlike the trend observed with current capital deployed, the majority (92%) of future committed and raised capital is being invested by impact investors.

INVESTOR MIX

For both currently deployed and future committed impact capital, DFIs represent the significant share of investment and therefore, tend to drive the trends in the market. As Figure 14 illustrates, DFI investments represent approximately 67% of currently deployed impact capital and 87% of future committed impact capital. In addition to the crucial roles as a direct source of capital for enterprises and as anchor investors in funds, DFIs play two important roles: (i) As “first movers,” they send a critical market signal to other investors, which should help to catalyze additional investments (although it is too early to see these effects); and (ii) as international investors with government links, they engage on policy issues and provide extensive policy support.

FIGURE 14: IMPACT CAPITAL BY INVESTOR TYPE



Source: Stakeholder interviews; Investor websites; Dalberg analysis

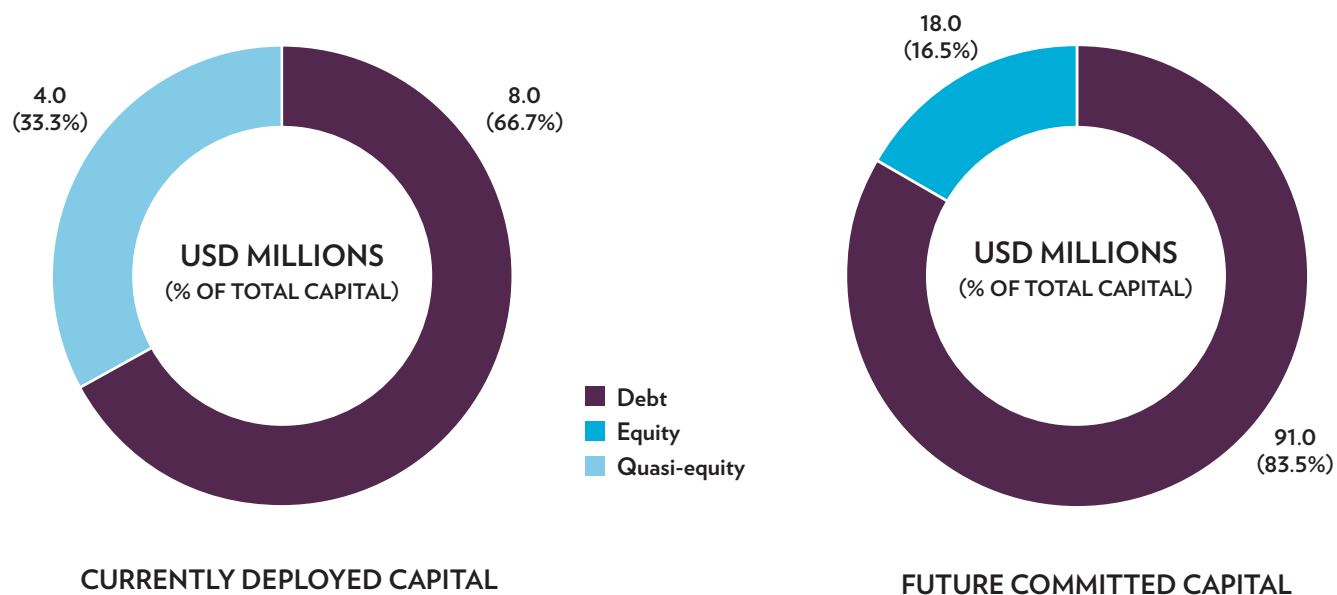
Key trends of impact investing in Myanmar

The following section examines trends among impact investors, who have collectively deployed USD 12 million and committed approximately USD 109 million for future deployment. The activities of impact-related investors (Ring 2) will be discussed in the section “Beyond the impact investing market.”

INSTRUMENT

The majority of currently deployed impact capital and future committed impact capital is in the form of debt. This is largely due to the type of investor deploying capital—since the majority of current and future capital is from DFIs, as stated above, the preference for debt is more visible. However, regulations in Myanmar prohibit debt-lending by most foreign investors (as they require a local banking license or must be registered as financial institutions). Therefore, they are restricted to equity or other instruments. It is actually fairly challenging for Burmese enterprises to take on debt from foreign investors, as these enterprises require special permission and a waiver from both the Central Bank of Myanmar and the Myanmar Investment Commission (MIC) to be able to accept foreign debt. Given this, one would expect to see a greater amount of equity funding as a greater number of impact investors engage in Myanmar in the future.

FIGURE 15: IMPACT CAPITAL BY INSTRUMENT



Sources: Stakeholder interviews; Investor websites; Dalberg analysis. Note: Equity calculation in future capital includes quasi-equity instruments, as exact breakdown between pure equity and quasi-equity is unknown.

Impact investors deploying equity have returns expectations that vary between 10% and 20%. While impact investors have return expectations ranging from 10% to 20%, conventional investors generally seek 20%–30% returns. In terms of tenure, or time horizon, investors are targeting five- to seven-year tenures but recognize that seven to ten years is more feasible given the maturity of the enterprise market. Lastly, a majority of equity investors seek a minority stake in the enterprise and often provide technical assistance/management support alongside capital (e.g., by seconding staff directly to the enterprise).

GROWTH STAGE AND DEAL SIZE

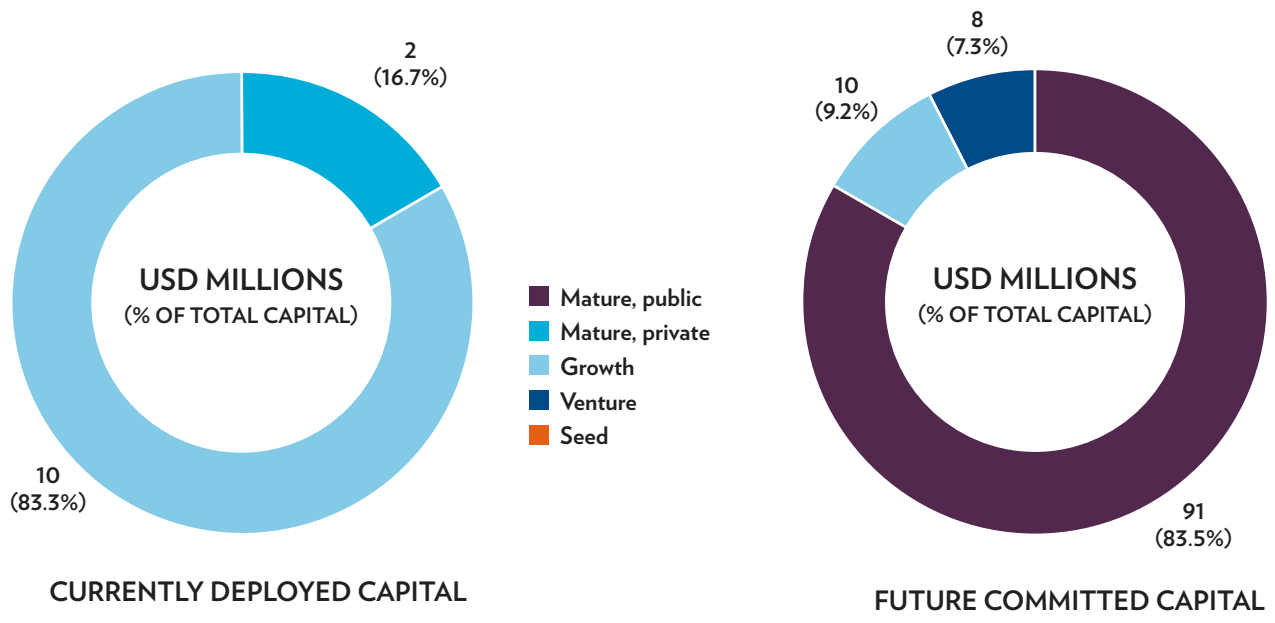
The majority of current investments are in growth-stage enterprises, while close to 84% of future committed capital is planned to be invested in mature companies (Figure 16). A primary driver of investments flowing into mature companies, particularly for future committed capital, is the continued preference of DFIs to invest in private, large-scale real-estate projects. Other features of mature companies that make them attractive include

- ability to absorb a larger amount of capital;
- ability to meet investor operational requirements—i.e., have established financial histories as well as operational and management experience as compared to the lack of financial records, business knowledge, and management experience that characterizes many start-ups/SMEs; and
- being easier to identify when entering the market.

However, investors are conscious that many of the large local enterprises have links to the previous regime and are wary of investing in organizations with these ties, reporting a preference for internationally backed large-scale enterprises instead.¹¹⁷

¹¹⁷ Under the previous regime, enterprises were often seized by the military, or when successful, would have “cronies” inserted on their boards.

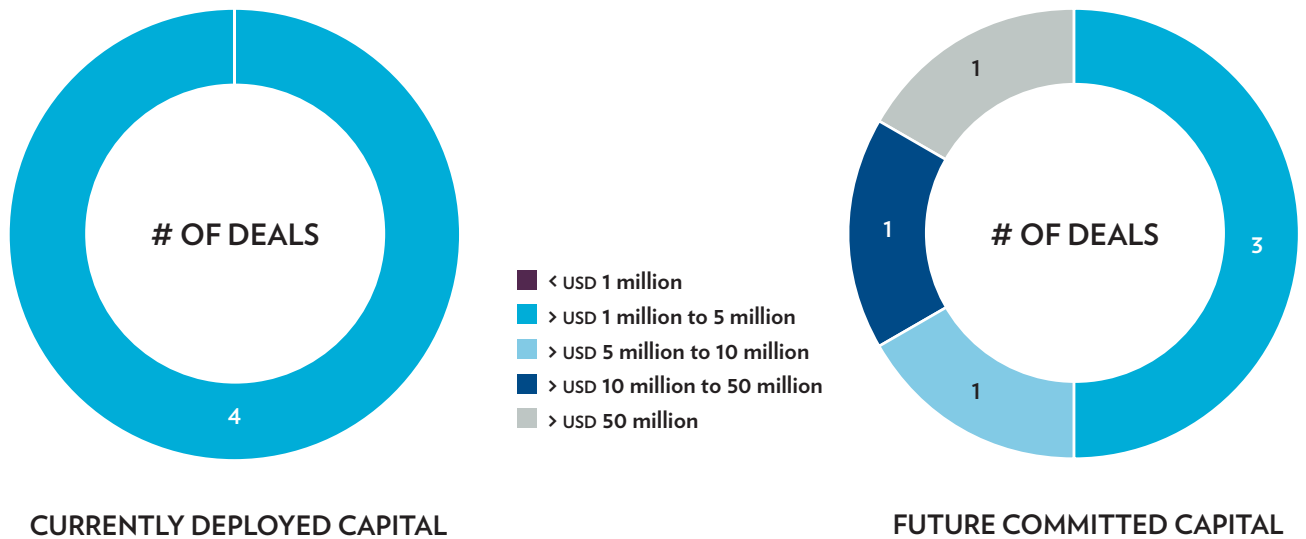
FIGURE 16: IMPACT CAPITAL BY GROWTH STAGE OF INVESTMENTS



Source: Stakeholder interviews; Investor websites; Dalberg analysis

Few current and expected future impact investment deals in Myanmar range from USD 2 million to USD 80 million. With so few deals known, it is not possible to comment on average deal sizes or investor preference vis-à-vis deal sizes. For future committed capital, we see a few larger deal sizes as DFIs plan to deploy larger ticket-size investments into growth- and mature-stage enterprises.

FIGURE 17: IMPACT CAPITAL BY DEAL SIZE



Sources: Stakeholder interviews; Investor websites; Dalberg analysis. Note: One co-investment deal was evenly split across three investors due to lack of further information; this does not skew the results.

SECTOR

While all the impact capital currently deployed has been invested in the financial services sector, a majority of future committed capital has been directed towards non-impact enterprises in the tourism sector. As seen in other countries, impact investments in the financial services sector seem to be an entry point for investors to engage. Opportunities for investment are seen in MFIs and banks that can on-lend to SMEs. The following factors drive interest in the microfinance and financial services sectors:

- **Investor familiarity with MFIs/banks.** Their model is well understood, and they are easy to both identify and access. In addition, there are simply a large number of MFIs in Myanmar (see the “Needs and opportunities: The demand side” section for more details).
- **High demand for microcredit due to low access to finance.** The market is far from being saturated—signaling high growth potential in the sector. The formal banking sector has limited outreach (recent research suggests only 4% of the population is formally banked), and informal providers of credit are risky and expensive (10%–20% monthly as credit, or around 200%–300% at an effective annual compounded rate of interest).¹¹⁸ Demand for microcredit is estimated at USD 1 billion by industry experts,¹¹⁹ with demand for microfinance in Myanmar outstripping supply by a factor of four.¹²⁰
- **Favorable regulations for MFI investments as compared to those for other sectors.** The new Microfinance Law (passed in 2011) allows local and foreign investors to establish fully privately owned MFIs,¹²¹ which has allowed ACLEDA Bank (a well-known leading global provider) to open in Myanmar, and may encourage other big international MFIs to follow suit.¹²² The ability to invest in banks that can on-lend to SMEs will depend on implementation of the new SME Law (2014).

Future investments are driven by DFIs’ aim to stimulate the economy through the development of tourism infrastructure and the dearth of investible enterprises in other sectors. USD 91 million has been committed by investors to tourism infrastructure in the next two to five years.

118 “Baseline survey results,” LIFT, 2012. Accessible at - <http://lift-fund.org/lift-in-action/content/liftbaseline-survey-results-2012>

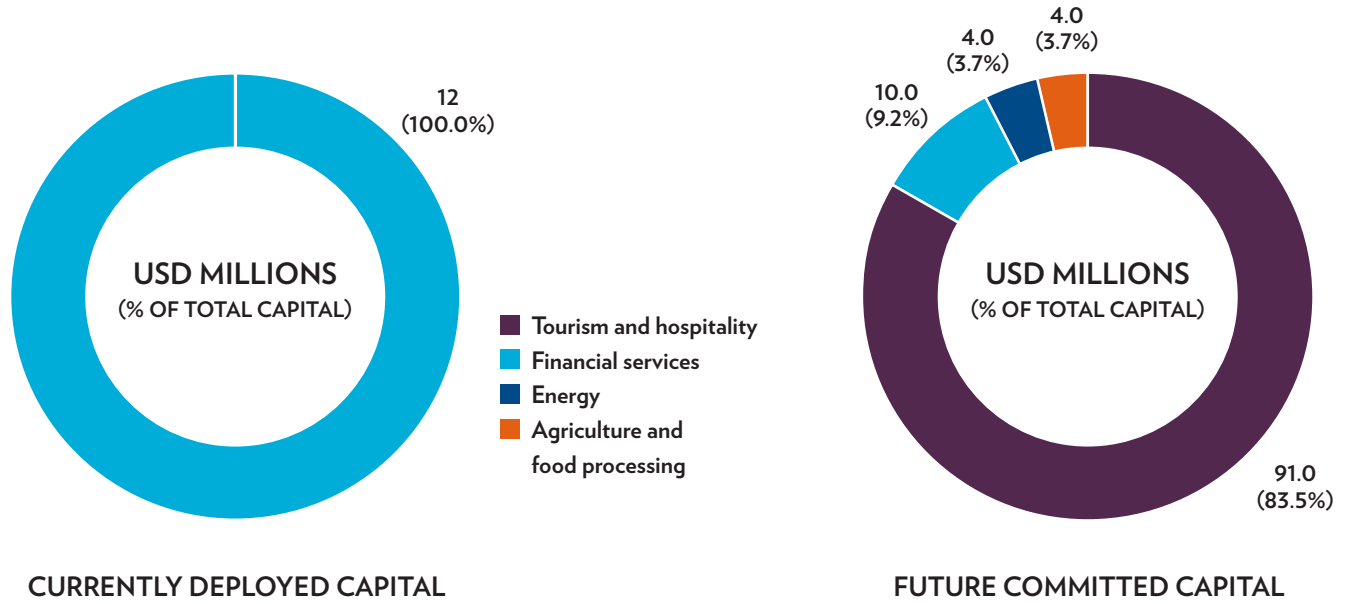
119 “UNDP formative strategic review of microfinance investments in Myanmar: Issues and recommendations for the future,” United Nations Capital Development Fund, (2012).

120 Duflos, E., Luchtenburg, P., Ren, L., and Yan Chen, L., “Microfinance in Myanmar sector assessment,” IFC Advisory Services in East Asia and the Pacific, CGAP, 2013.

121 “Op Cit.,” CGAP, 2013.

122 Although revisions are expected, the MFI law still has issues that need to be ironed out; for example, some law directives do not follow global best practices such as a capped interest rate spread and low minimum capital requirements.

FIGURE 18: IMPACT CAPITAL BY SECTOR



Sources: Stakeholder interviews; Investor websites; Dalberg analysis. Note: For future committed capital, an assumption has been made that one investor will invest equal share of committed capital in energy and agriculture.

Impact measurement

With respect to measuring impact, investors who have deployed, or who plan to deploy capital, either use established measurement systems such as the Global Alliance for Banking on Values (GABV) scorecard or customize their metrics (typically using IRIS¹²³). As in most markets, there are standardized, customized, and anecdotal forms of impact assessment. DFIs and banks tend to use established impact measurement systems or customize their metrics. Currently, the most common forms of assessment are standardized assessments due to the use of these by DFIs. However, when funds and fund managers start to enter the market, we will most likely see a change in the types of assessments used, including an increase in the use of customized and anecdotal impact assessments.

FIGURE 19: IMPACT MEASUREMENT SYSTEMS BEING EMPLOYED BY INVESTORS

	Metric-based Impact Measurement	Anecdotal Impact Assessment
Rationale for approach	<ul style="list-style-type: none"> To assess effectiveness and improve operations To report performance in ways that reinforce public trust To present impact in a way that is understandable to stakeholders To understand progress towards mission of social and/or environmental impact 	<ul style="list-style-type: none"> Difficult for studies to quantitatively demonstrate the impact of microfinance. Do so by anecdote or have investee report its impact. Quantitative impact studies face two fundamental challenges: (a) their ability to capture and analyze all the benefits of microfinance, and (b) the duration of the study itself (researchers usually examine impact over 14-18 months; however, during this period, impact does not necessarily manifest itself).
Key indicators measured	<ul style="list-style-type: none"> Based on financial, economic, environmental, and social performance, and private sector development impact IRIS indicators with proprietary metrics that reflect impact requirement or fund Global Alliance for Banking on Values scorecard metrics Customized metrics in quarterly report dependent on sector of enterprise and impact it seeks to have 	<ul style="list-style-type: none"> Dependent on investee's report/uses individual stories or anecdotal evidence
Rationale for indicator selection	<ul style="list-style-type: none"> Use DOTS as it is recognized as a leading system for development-results measurement among IFIs/DFIs and allows for real-time tracking Use IRIS because of clarity of data and user-friendly interface, and because it provides independent, third-party set of metrics Customization of metrics needed given variation in the type of impact/sectors that the investees are involved in 	N/A

Sources: Stakeholder interviews; company websites

¹²³ IRIS (formerly known as Impact Reporting and Investment Standards) is a set of standardized metrics for impact measurement managed by the Global Impact Investment Network (iris.thegiin.org).

Beyond the impact investing market

Capital invested by impact-related investors in Myanmar totals approximately USD 43.6 million. A majority of this capital has been deployed by one infrastructure-focused fund manager (who received initial investment from a DFI) who is investing in mature companies. Other smaller investments have been in energy, microfinance, and ICT. The initial presence of angel investor groups and conventional investors making impact-related investments, along with the evidence of future commitments for capital in Myanmar, suggests the growth of the broader impact investing landscape in the future.

Challenges facing impact investors in Myanmar

In Myanmar, investors face challenges across the investment lifecycle. The most severe constraints are regulations pertaining to market entry, and low levels of enterprise investment readiness, which constrain pipeline development (Figure 20). As they look to enter the market, investors face restrictive investment policies and struggle to navigate complex investment approval processes. In particular, it is difficult to set up a new organization or office through official channels. For example, high fees (the company registration fee is USD 1,500) and complex procedures (extensive background checks and letters from the township and the local police station are required) restrict company registration.

The Organization for Economic Cooperation and Development (OECD) ranks Myanmar as having the second most restrictive FDI regulations in the world.¹²⁴ In particular, Myanmar ranks particularly poorly in two out of the four criteria considered in this ranking. Myanmar's foreign equity restrictions and its screening and approval processes for entering investors were rated as the most severe restrictions faced by foreign investors. Moreover, Myanmar is the only ASEAN (Association of Southeast Asian) country to have two laws for investment: one for local firms, and the other for foreign investors.

¹²⁴ The OECD FDI Regulatory Restrictiveness Index (FDI Index) gauges restrictiveness of a country's FDI and market access rules. The index examines four types of restrictions: approval or screening mechanisms for investment, foreign equity limitations, restrictions on the employment of foreigners as key personnel, and operational restrictions (e.g., capital repatriation and land ownership).

FIGURE 20: SEVERITY OF CHALLENGES FACED ACROSS THE INVESTMENT LIFECYCLE



Severity of investor challenges, by stage of investment



Key challenges faced by investors and severity of impact

Lack of basic and accurate macro-economic data for Myanmar	Cost of pipeline development is high. Few enterprises are investment ready; poor business skills compound issue	Challenge in separating military/political interests and ties with investments in large-scale enterprises	Interest rates capped by government at level that does not reflect investor risk	Limited local talent/capacity to oversee fund management	Unclear laws for protection of investor funds; uncertainty about legal recourse for lost investment ²
Complex and restrictive regulations for investors to enter	Lack of at-scale enterprises due to risk and need to remain small and diversify under previous regime ¹	Companies lack financial and operational records; not uncommon that they have not paid taxes		Weak entrepreneur business skills implies that investors have to be more engaged strategically and operationally	Majority of equity investments likely need to be structured with a 7-10+ years due to nascent enterprise market
Limited expertise and overlapping processes in investment approval authority					



Sources: Stakeholder interviews; Dalberg analysis; ¹Previous regime could seize businesses without notice, so to remain “below the radar” entrepreneurs tried to remain small scale and did not focus efforts too much on one business but rather saw diversification as an insurance policy or a hedging tactic. ²Companies doing business in Myanmar are not allowed to conduct arbitration for business disputes in foreign tribunals despite the dearth of dispute resolution mechanisms in country (e.g., commercial arbitration, mediation, and conciliation).

As highlighted in the FDI index, one of the most pressing challenges to entry is the level of complexity of the current regulatory framework in Myanmar, with over half a dozen laws regulating the entry of investors—many of them dating back to colonial times—depending on the sector and location of the investment.

The laws include an extensive list of sectors in which foreign investment is prohibited or restricted, with banking, fisheries, retail, and food as the most restrictive sectors for foreign investment.¹²⁵

Furthermore, despite initiatives to streamline investment procedures, the current system for investment remains complex, with investors needing to make a number of contacts with different ministries and local authorities. This further exacerbates the fact that the regulatory procedure provides significant discretion to

¹²⁵ OECD, 2014, and FDI Index online, 2013.

different government entities, minimizing transparency and equity in the process. In addition to the confusing approval processes, regulators have limited expertise and knowledge of financial instruments and investments, making the whole process slower and more cumbersome.¹²⁶

In terms of pipeline development, the most significant challenge is that there are few investment-ready enterprises. Poor business, financial, and operational knowledge and skills among enterprises compounds this issue, particularly for conducting due diligence and screening of the organization (see the “*Needs and opportunities: The demand side*” section for more details). In addition, due to the constant takeover and nationalization of large-scale enterprises during Myanmar’s recent military regime, entrepreneurs today are still in the habit of diversifying businesses rather than specializing in and growing a specific business to a large scale.

Finally, at the end of the investment cycle, weak investor protection laws remain a challenge. While the enactment of the FIL (2012) was a step forward to opening up the market to investors, it still leaves questions unanswered, particularly those related to investor protection in the management of investments and exits. Although under the new FIL, the level of protection granted to investors has been enhanced, mechanisms for enforcing contracts and property rights and for settling disputes remain weak.

¹²⁶ Myanmar impact investor interview, July 2014.

NEEDS AND OPPORTUNITIES: THE DEMAND SIDE

Overview of the impact enterprise ecosystem in Myanmar

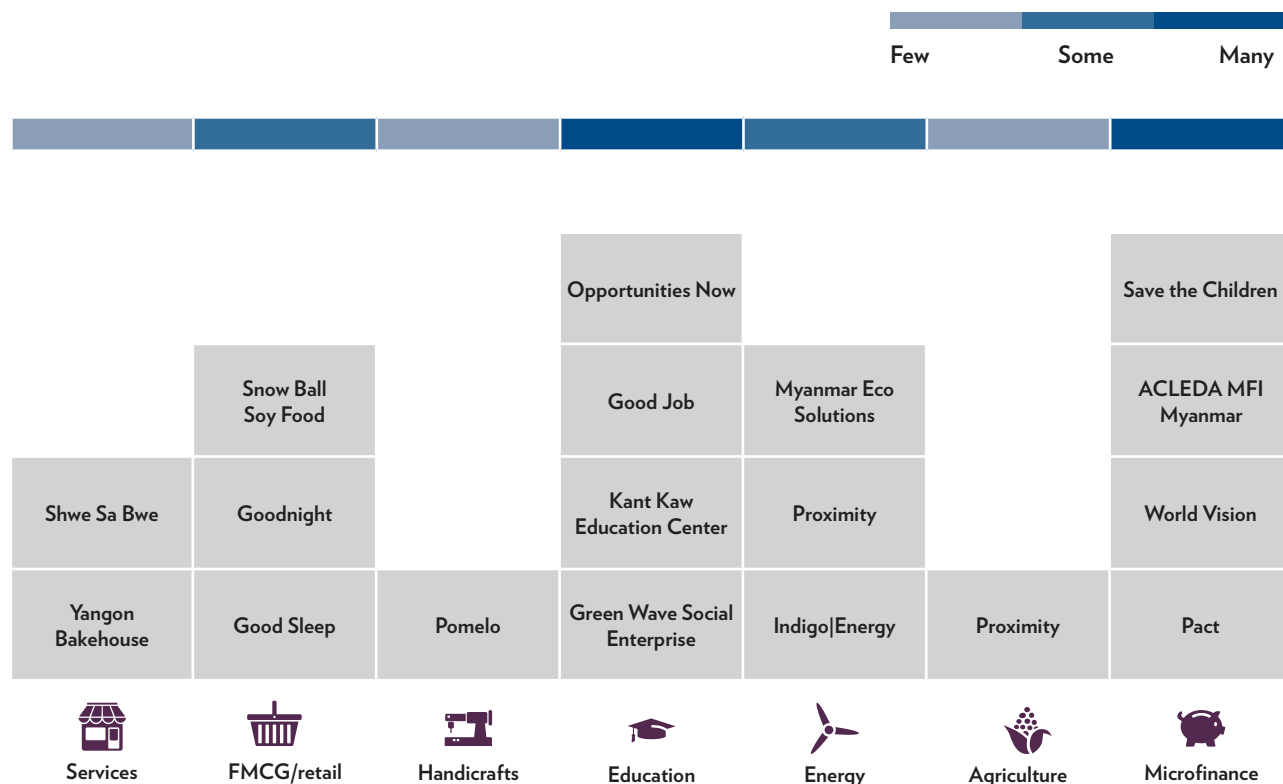
When examining the flow of impact capital, we see very little directed to impact enterprises.¹²⁷ However, there is increasing investment interest in enterprises in the financial inclusion sector (almost 40% of current capital has been deployed into financial inclusion, and potentially 24% of future committed capital will flow to this sector) and fast-growing SME sectors such as tourism. Although a majority of impact enterprises interviewed in Myanmar had not taken or solicited capital from impact investors, two angel networks have invested around USD 630,000 into two different seed-stage impact enterprises.

Besides the presence of large or expanding international MFIs, the formal impact enterprise space in Myanmar is extremely small and active only across a few sectors. These MFIs include established large international MFIs (e.g., Pact, World Vision, Proximity MFI, and GRET), that helped pioneer microfinance models and sustained the models through sanctions. As a result, these MFIs have had a much longer period of operation than emerging impact enterprises. More recently established impact enterprises are emerging in the education/vocational training space and in rural areas (Figure 21).

According to some impact investors, there are more at-scale impact enterprises started by local entrepreneurs in rural Myanmar (e.g., in the agriculture sector) than there are in urban areas. However, a combination of the facts that investors tend to focus on urban centers and that these rural enterprises do not self-define as impact enterprises (or are not necessarily aware of the concept), makes the identification of rural impact enterprises more challenging. The implication of these two trends is that investors will likely need to reach outside of urban centers to seek these emerging rural impact enterprises in order to increase their pipeline development and, ultimately, impact. Moreover, this unusual concentration of impact enterprises in rural areas means investors need to seek enterprises directly through hands-on pipeline development (e.g., field visits with local contacts).

¹²⁷ *Impact enterprises for the purposes of this report are defined as those that have articulated a core objective to generate positive social or environmental impact (i.e., as a part of their operating model rather than an ancillary activity as with CSR programs) and seek to grow to financial viability and sustainability.*

FIGURE 21: RELATIVE NUMBER OF IMPACT ENTERPRISES BY SECTOR, WITH EXAMPLES



Sources: Stakeholder interviews; Organization websites; Dalberg analysis; British Council (2013) Social Enterprise Landscape in Myanmar

Despite high official literacy rates, a large population of working-age adults (the median age in Myanmar is 27 years) lacks skills training and education; skill development is therefore essential for Myanmar’s growth. The education and vocational training sector includes impact enterprises that work in targeted skill building, or education across different fields—from basic preparation for higher education and college (Kant Kaw Education) to industrial garment training (Good Job) to rural development (Green Wave Social Enterprise) to entrepreneurship (Opportunities Now).

FIGURE 22: FIVE LEGAL FORMS OF INCORPORATION FOR ORGANIZATIONS IN MYANMAR

Legal Form	Characteristics	Challenges in incorporation	Difficulty of incorporation	Examples
Foundations	<ul style="list-style-type: none"> Normally financially supported by private sector company Typically funded from donations from a single source and/or small donations 	<ul style="list-style-type: none"> Activities/direction may be driven by founder interests rather than being needs-based 		Shwe Minn Tha Foundation
Cooperatives	<ul style="list-style-type: none"> Owned/controlled by its member Legal status makes it easier to introduce revenue generation activities History of government support 	<ul style="list-style-type: none"> Closer control by the government, decreased independence 		Good Sleep
Associations	<ul style="list-style-type: none"> Focus on religious or specific social issues Legal form adopted by many local NGOs due to faster/easier registration process 	<ul style="list-style-type: none"> Difficult to generate revenues due to law limiting their ability to issue invoices for services 		Byamaso Social Services
NGOs	<ul style="list-style-type: none"> Despite challenges, local NGOs are becoming more active players in addressing community issues Face suspicion by government as vehicles for opposition movements 	<ul style="list-style-type: none"> Registration process is long, unpredictable, and costly Regulations pose restrictions on operations (e.g. use of bank accounts, inability to generate revenue) 		Proximity
Private Companies	<ul style="list-style-type: none"> Relatively easier to register as private company (rather than an NGO) Newer impact enterprises starting to register as private companies Able to receive donations, in-kind donations, and grants 	<ul style="list-style-type: none"> Concept of for-profit impact enterprises still new to Myanmar 		Yangon Bakehouse Pomelo

○ Least severe
● Most severe

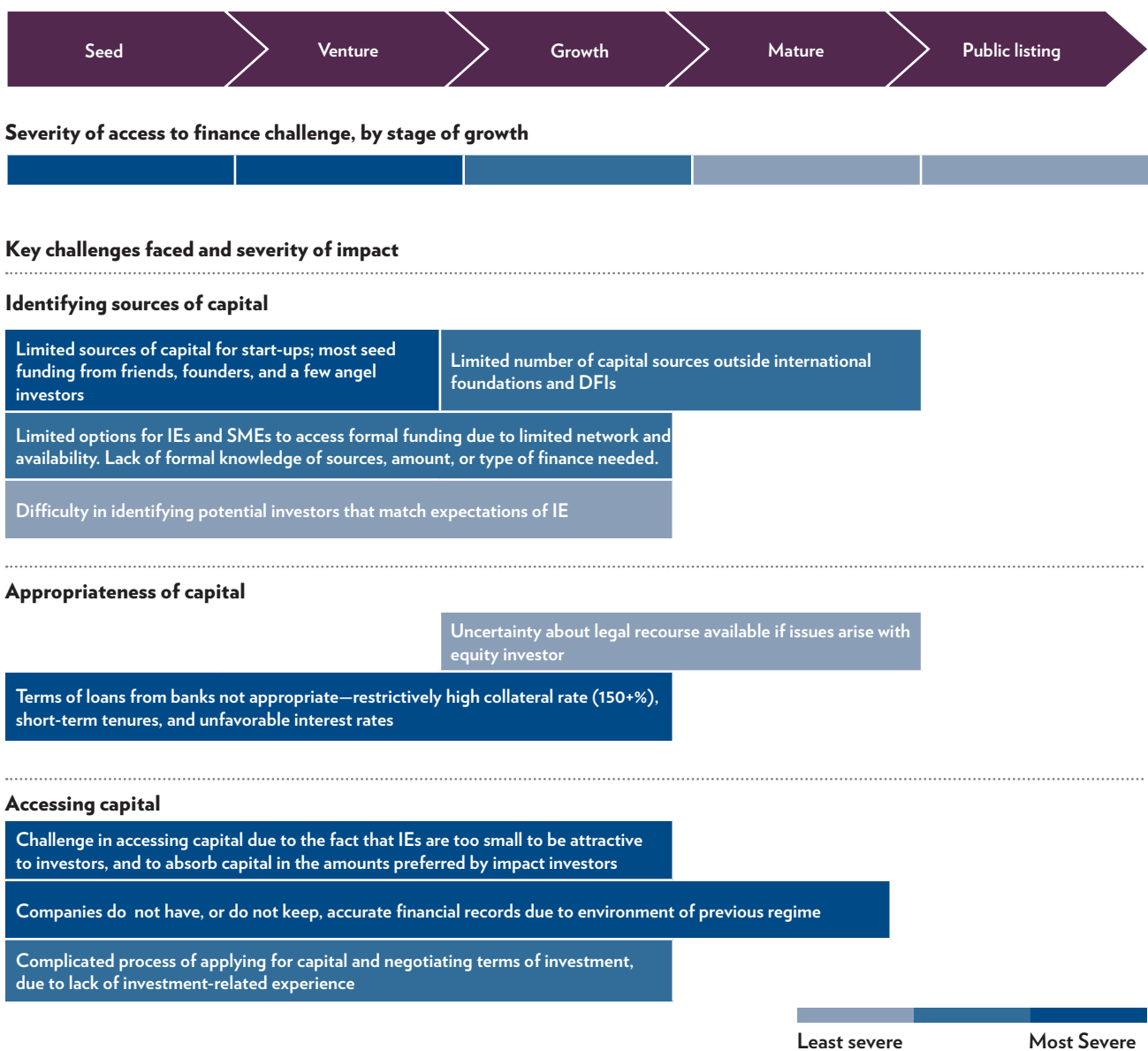
Sources: Stakeholder interviews; British Council (2013) Social Enterprise Landscape in Myanmar

While the impact enterprise model is still a relatively new concept in Myanmar, government perceptions and registration processes may inadvertently create momentum towards it. Organizations seeking to generate social impact will likely register as private companies and adopt an enterprise approach rather than forming as NGOs; entrepreneurs may shy away from NGO structures, which have typically faced suspicion by government (due to perceptions that they serve as vehicles for opposition movements) and as such face costly and lengthy registration processes and monitoring of activities (Figure 22).¹²⁸ This may lead entrepreneurs to either adopt enterprise structures or remain informal and unregistered.

¹²⁸ Social enterprise landscape in Myanmar, British Council, 2013.

The legal form adopted by organizations also has implications for revenue generation and financial sustainability. NGOs and associations are limited by law in their ability to generate revenue from their activities. Cooperatives are allowed to establish a revenue stream due to their historical ties with government, but they have less independence and are more closely controlled by the government, making a new venture or revenue stream slower and more cumbersome to establish. Foundations typically do not seek to become revenue-generating entities; rather, they depend on grants and donations, and are largely supported by donations from private sector companies. Therefore, we see newer impact enterprises becoming established as private companies (e.g., Pomelo and Yangon Bakehouse) as the registration process is relatively easy, revenue generation is allowed, and enterprises are still allowed to receive donations, grants, or in-kind donations.

FIGURE 23: SEVERITY OF ACCESS TO FINANCE CHALLENGES BY ENTERPRISE GROWTH STAGE



Sources: Stakeholder interviews; Dalberg analysis

Although access to finance ranked as the sixth biggest challenge in a survey of 1,100 SMEs, as in other markets, these challenges vary with growth stage and size of the enterprise; access to finance is more constrained for smaller, early-stage companies. One ecosystem player who supports SME development attributes this lower ranking to low entrepreneur awareness of its own finance needs. Further, due to Myanmar's historical instability, SMEs are not in the habit of long-term planning and usually tend to not have growth plans. However, of the 1,100 enterprises surveyed, around 60% responded that they would like to access a formal loan, while only 14% have actually been able to do so.¹²⁹

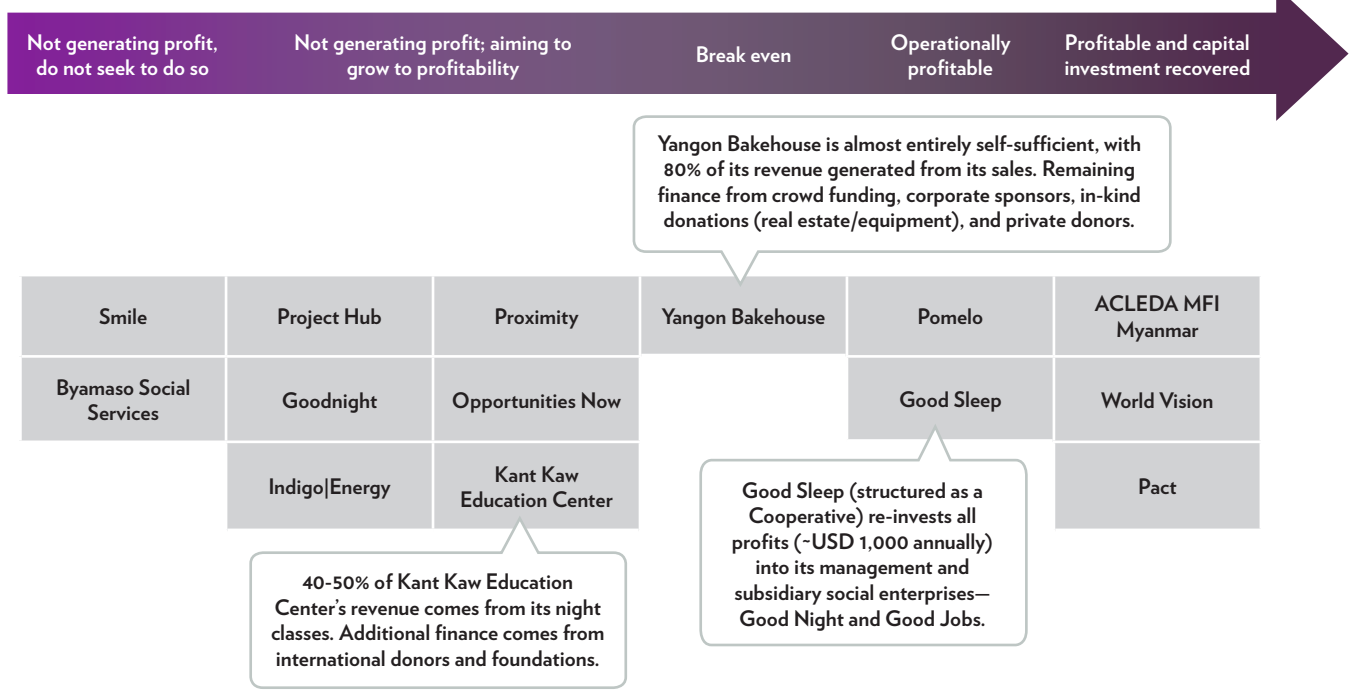
As illustrated in Figure 23, access to finance constraints are driven not only by availability of capital, but also by factors such as the lack of networks to identify capital, knowledge of appropriateness of finance to suit the needs of the enterprise, and the process of accessing capital. In terms of availability of capital, there are few formal options available to entrepreneurs: only the Small and Medium Industrial Development Bank has a specifically tailored SME product. By and large, commercial debt products are inappropriate for the needs and capacities of small enterprises: They require 150–300% of the loan value in immovable capital as collateral; have short tenure terms of less than one year rather than providing longer-term capital with grace periods appropriate to the business model; and have high interest rates (13%) fixed by the Central Bank.

As a result, enterprises lacking access to capital in appropriate forms have had to self-finance through their informal networks, donations, and grants or try to sustain themselves through their revenues. However, this trend may change as the scale and exposure of impact enterprises increases.

¹²⁹ "Survey results of 1,100 Building Market-affiliated SMEs in Myanmar," *Building Markets*, 2014.

FIGURE 24: SOURCES OF FINANCE AND FINANCIAL SUSTAINABILITY FOR A SAMPLE OF IMPACT ENTERPRISES IN MYANMAR

Financial sustainability of sample impact enterprises



Sources: Stakeholder interviews; British Council (2013); Dalberg analysis

Other constraints to enterprise growth

According to a survey of 1,100 SMEs,¹³⁰ the top three challenges to SME growth in Myanmar are infrastructure, business skills, and government policies. Access to finance ranked sixth out of 14 options. Weak infrastructure (see Country context: Challenges to investment) is a major challenge for enterprises that require strong ICT infrastructure, transport for goods, robust supply chains, and access to consistent and reliable power.

The second most significant constraint to enterprise growth is business capability. The most significant barrier to the growth of enterprises, and to their investment-readiness, is their lack of operational and financial management skills. Skill gaps include the following:

- Low levels of understanding of financial instruments needed to fund/grow their enterprise
- Lack of familiarity with business plans or growth plans
- Weak operational and human resources management systems
- Limited service providers supporting business development services

¹³⁰ According to the 2011 Revised Private Industrial Enterprise Law, SMEs are defined as having annual revenues up to USD 2,600, with 10 to 50 employees, while medium-sized enterprises are classified as having annual revenues between USD 2,600–USD 5,000, with 50 to 100 employees.

FIGURE 25: ENTERPRISE RANKING OF CONSTRAINTS TO GROWTH; SURVEY OF ~1,100 SMES IN MYANMAR, 2014

BUSINESS ENVIRONMENT CONSTRAINT	PERCENTAGE OF RESPONSES RATED AS TOP TWO CONSTRAINTS
Infrastructure	21%
Lack of business skills	13%
Exchange rate	13%
Government policies	13%
Competition	11%
Access to finance	7%
Political instability	5%
Lack of information	4%
Lack of equipment	4%
Taxes	3%
Lack of customer base	2%
Corruption	1%
Language	1%
Insurance	1%

Sources: Building Markets, Overview of the SME Sector in Myanmar (Emmanuel Maillard, 2014). Note: Respondents to survey were not evenly distributed across sectors or functions, and this bias may affect the extent to which some challenges are perceived and represented. Respondents as follows: 36% Wholesalers, 29% Service providers, 22% Manufacturers, 10% Traders, and 2% Retailers.

In addition to skill gaps, another constraint is the general mindset of business managers. To respond to the risks faced under the previous military regime, in which all non-agricultural medium to large enterprises were nationalized, entrepreneurs are accustomed to diversifying their businesses into numerous micro-enterprises, rather than focusing on one enterprise and growing it to maturity. In addition, enterprises undertake little to no financial record-keeping either due to a lack of financial skills, or as a deliberate strategy that has lingered from the days of the previous military regime, which used financial records to the detriment of the enterprise.

Enabling impact investing: The ecosystem

As previously discussed, Myanmar’s investment climate—including its macro-economic governance, infrastructure, political stability, and regulatory framework—is a significant constraint to investment. More specifically, the two most important constraints to investment into Myanmar are its lack of infrastructure and complex regulatory environment. In response to regulatory and infrastructure challenges, DFIs, bilaterals, and the Myanmar government are prioritizing work in regulatory reform and infrastructure improvement (Figure 26). Ongoing efforts are being undertaken by the Myanmar government, particularly through the Directorate of Investment and Company Administration (DICA), with DFI partners (IFC, ADB, World Bank, etc.) to identify and implement regulatory reforms and streamline legislative processes. Moreover, the ADB, alongside the Myanmar government, has been working to help develop basic infrastructure, particularly that of the roads and power.

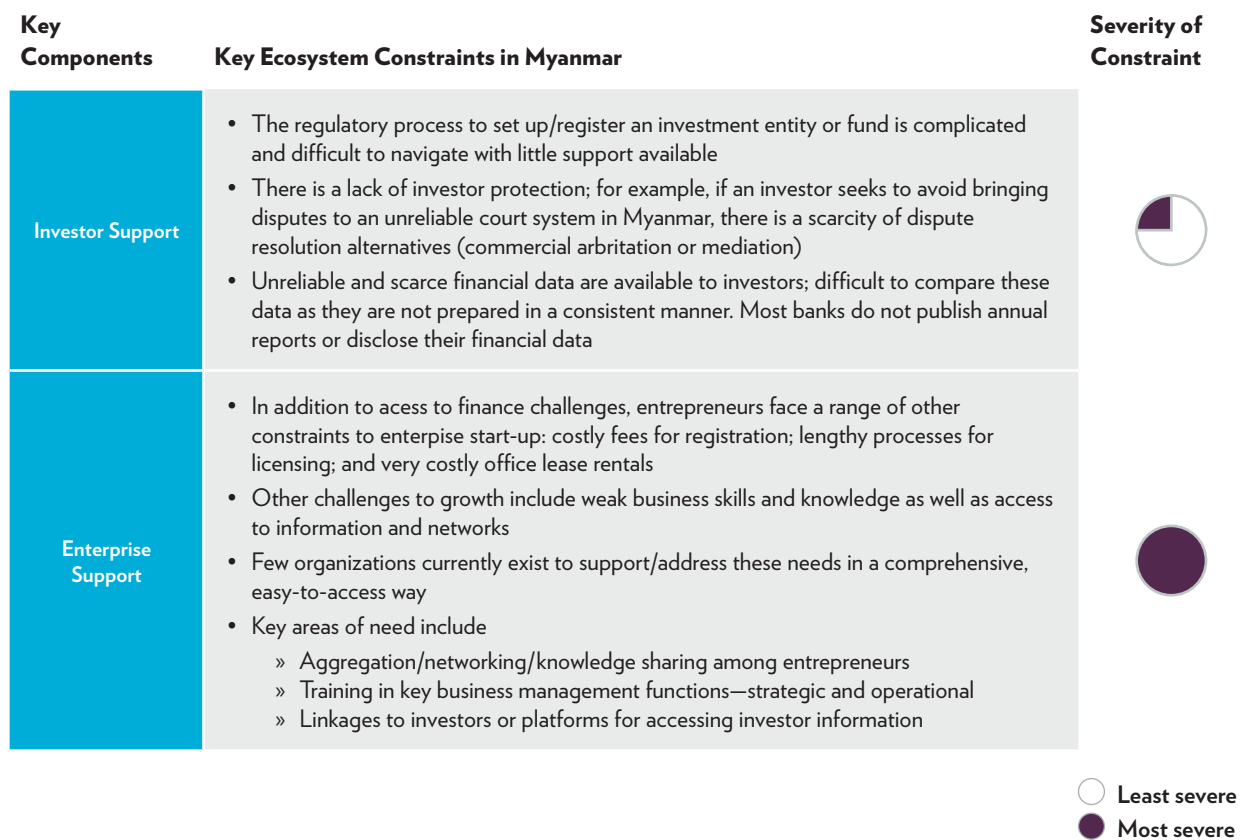
FIGURE 26: ROLES AND ACTIVITIES OF SAMPLE PLAYERS IMPROVING INFRASTRUCTURE AND INVESTMENT REGULATIONS

	Role/Mandate in Myanmar	Sample Activities in Myanmar
International Finance Corporation	<ul style="list-style-type: none"> Began work in Myanmar in 2012 Key functions include undertaking of infrastructure, legal and regulatory assessment of the country’s investment climate to help focus future activities; undertaking a business environment perception survey of SMEs 	<ul style="list-style-type: none"> Tackling regulatory issues through Investment Climate Reform including business registration, process of investment approvals, taxation regime Working to improve and promote public-private partnership initiatives and establish a business forum
UK Department for International Development	<ul style="list-style-type: none"> Key functions include providing good governance and public financial management; promoting responsible investment; improving transparency; strengthening the work of parliament; supporting the process of ethnic reconciliation 	<ul style="list-style-type: none"> The Peace Support Fund will fund projects in Myanmar that provide tangible support to the peace process and support cross-sector dialogue, such as negotiations preparation and training.
Asian Development Bank	<ul style="list-style-type: none"> Resumed operations in 2013 Key functions include initial lending and investment grant operations focused primarily on access, connectivity, and infrastructure development, specifically in energy and urban planning 	<ul style="list-style-type: none"> Provided loans for updating the national electricity grid, ensuring infrastructure bidding process is transparent/updated to international standards Working with the World Bank on an investment climate assessment of Myanmar
Directorate of Investment and Company Administration	<ul style="list-style-type: none"> Established in 1993, DICA is under the Ministry of National Planning & Economic Development Key functions include appraisal of projects proposed for investment, registration, and administration of investments, monitoring of permitted enterprises 	<ul style="list-style-type: none"> Taking steps to rationalize legislative framework, manage and streamline regulations and procedures for business

Sources: Stakeholder interviews; Investor websites; Dalberg analysis. ¹UK Government call for proposals, The South East Asia Prosperity Fund: <https://www.gov.uk/government/publications/south-east-asia-prosperity-fund-2014-2015>

Beyond the macro investment climate, support services to investors and enterprises are crucial elements to enable an impact investment ecosystem. For investors, there is little support available to navigate the complex and changing regulatory processes (Figure 27). Access to reliable financial information on enterprises and macroeconomic data on Myanmar is very difficult, if not impossible, for investors to obtain or generate. Enterprises require support in key areas including access to networks of investors or platforms with investor information, as well as training in key business management functions.

FIGURE 27: CONSTRAINTS TO INVESTOR AND ENTERPRISE SUPPORT IN MYANMAR



Sources: Stakeholder interviews; Dalberg analysis

Lack of adequate training, advisory services, and platforms for networking and aggregation remain significant constraints to the growth of the impact investing industry. For investors, as discussed, identification of investment-ready enterprises is a key constraint to deployment of capital, and the cost of developing these enterprises is often prohibitive. Without a supportive ecosystem working to build these enterprise models, the industry will remain far below its potential size and impact.

FIGURE 28: EMERGING PLAYERS IN THE ENTERPRISE SUPPORT LANDSCAPE IN MYANMAR

Incubators/Accelerators



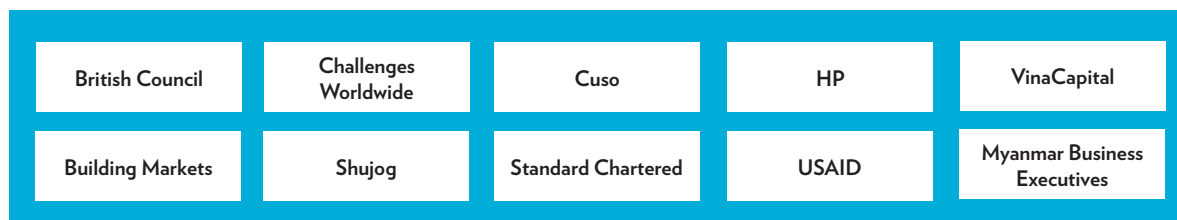
Advisory Services



Credit Rating Services



TA Providers






Sources: Stakeholder interviews; Investor websites; Dalberg analysis

An ecosystem of support for targeting skill gaps and training impact enterprises in business skills, including operational and financial management, is beginning to emerge. In recent times, there has been an advent of both distinct organizations (such as Sustainable Business Myanmar and Building Markets) targeting support to impact enterprises and joint ventures emerging to address training and skillset gaps and needs. Examples of such joint ventures include the British Council working with Standard Chartered Bank to provide free business development training to select enterprises, and Hewlett Packard working alongside Vina Capital and USAID to provide both funds and in-kind resources for SME training. This ecosystem is aiming to support and address the most significant gaps that impact enterprises face and are an indication of the growing demand for these types of services.

As these support services are still slowly being developed on the enterprise side, there is a reasonable ecosystem emerging to provide advisory services to investors, including logistical support, market analytics, deal sourcing, structuring, and due diligence. Figure 29 describes some of the services being offered to help investors overcome key challenges to investment in Myanmar.

FIGURE 29: INVESTOR SUPPORT SERVICES IN MYANMAR

Key gaps identified by investors to investment	Severity of gap	Example of organizations offering advisory services	Services being offered
Challenges in launching a new office/entity in Myanmar		<ul style="list-style-type: none"> • Fine 9 	<ul style="list-style-type: none"> • Administrative start-up support: Assists investors to establish a legal entity in Myanmar, assists with approvals, permits, and office space.
Lack of reliable market data for investment decision-making		<ul style="list-style-type: none"> • Andaman Capital Partners • MiTA • Ronoc • ThuraSwiss • Mandalay Capital 	<ul style="list-style-type: none"> • Consultancy: Numerous enterprises provide business development analysis for their clients as well as sector-specific market research, and the analysis of the risks/returns of investments.
Lack of deal-sourcing information		<ul style="list-style-type: none"> • Andaman Capital Partners • Mandalay Capital • M Invest 	<ul style="list-style-type: none"> • Deal sourcing: These investment advisory firms seek direct investment opportunities for investors (as well as advise local companies on raising capital). They help source, structure, and close deals and investment projects.

Sources: Stakeholder interviews; Investor websites; Dalberg analysis

AREAS FOR FUTURE RESEARCH

As the impact investing market in Myanmar is nascent, follow-up research will be important to monitor the nature and direction of market growth. As we are already seeing a large amount of committed capital by impact investors, tracking the deployment as well as the progress of deals already made would be valuable. Secondly, given a clear interest among DFIs in the tourism sector, we would propose an exploration of these investments in greater depth, in terms of their viability and potential for impact. Lastly, there are several conventional investors from other parts of South Asia exploring possibilities of investment in Myanmar. It would be worthwhile to follow-up with these investors to explore whether there are any possibilities for making impact-related investments.

INDIA

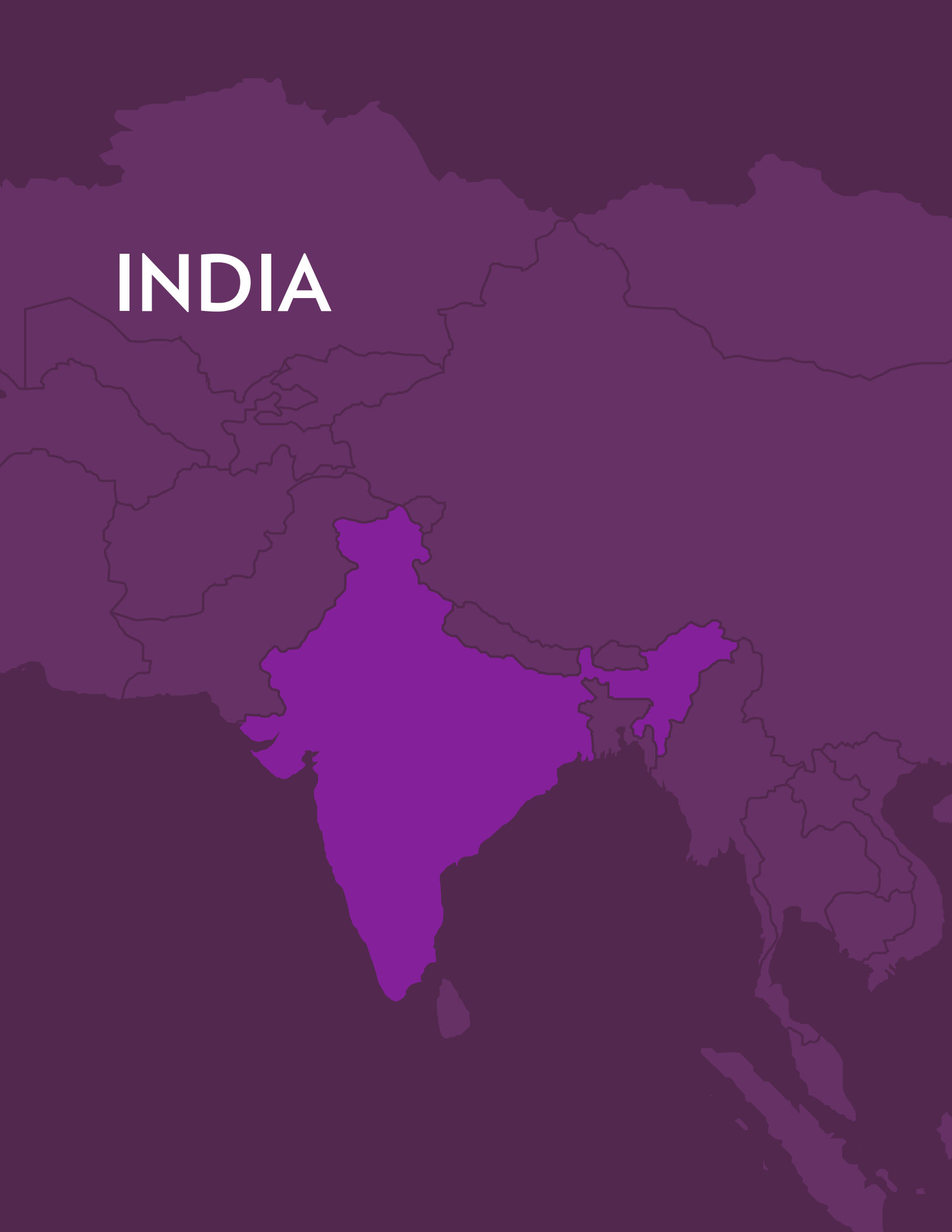


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COUNTRY CONTEXT

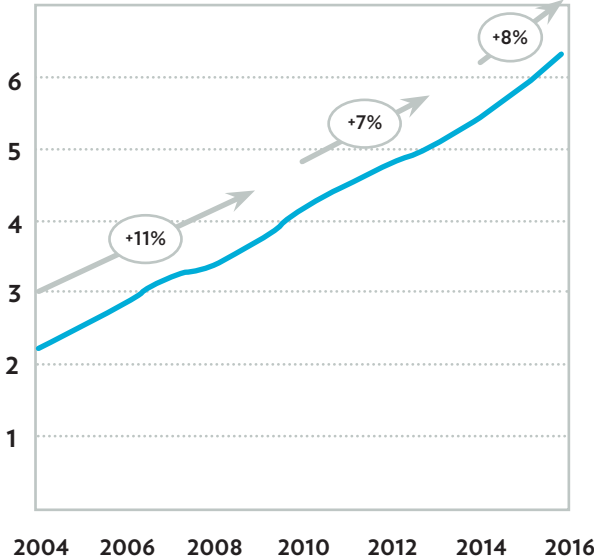
GDP growth and drivers of foreign direct investment (FDI)

India is the leading economy in South Asia, and the third largest in the world in PPP terms, with a GDP of international USD 6.3 trillion in purchasing power parity (PPP) terms. However, growth has slowed since 2010 (see Figure 1). India has been at the forefront of the developing world since the early 2000s, with a rapidly growing economy. Between 2004 and 2009, India’s PPP GDP grew at an annual average of 11%. However, in the aftermath of the global debt crisis, and in the face of poor coalition governance as well as “policy paralysis,”¹³¹ growth slowed in 2010. Going forward, the International Monetary Fund (IMF) predicts a gradual recovery for India. In particular, the IMF estimates that India’s PPP GDP will grow at an average annual rate of 8% as macroeconomic conditions improve.

FIGURE 1: GDP (PPP) OF INDIA AND COMPARISON WITH OTHER SOUTH ASIAN COUNTRIES (2013, 2014-2016: PROJECTED)

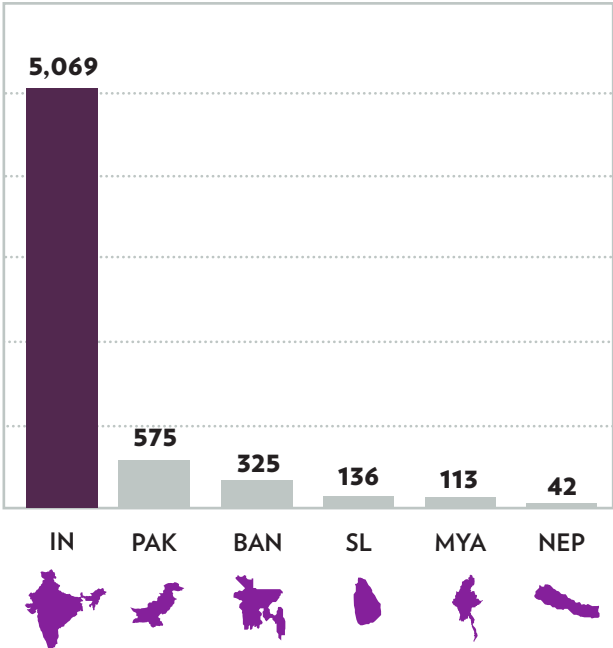
GDP OF INDIA

(PPP, CURRENT INTERNATIONAL DOLLAR, TRILLIONS)



GDP BY COUNTRY

(PPP, CURRENT INTERNATIONAL DOLLAR, BILLIONS, 2013)

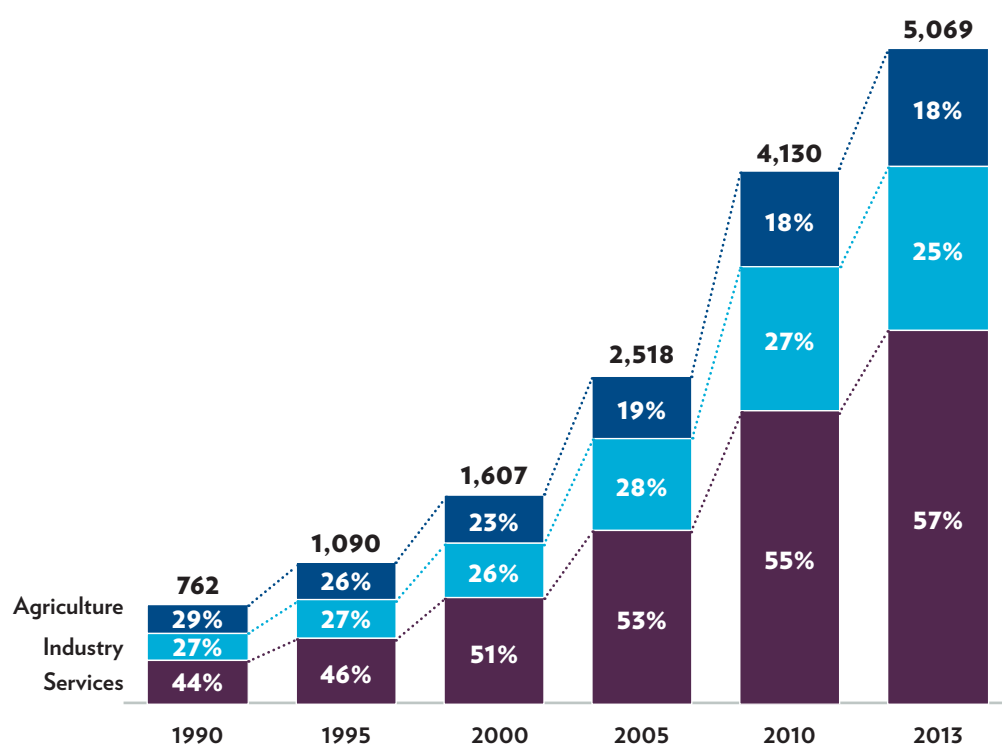


Source: IMF World Economic Outlook Database 2014

131 “Policy paralysis’ responsible for India’s slowdown,” Firstpost.com, September 8, 2013.

India's services sector has been the key contributor to its growth, accounting for more than half of GDP growth after 2000 (see Figure 2). Since India began liberalizing its economy in the 1980s, the services sector has grown in contribution to India's GDP, whereas agriculture and manufacturing have progressed slowly and seen a decline in contribution. According to the Indian Economic Survey 2014, India has one of the fastest growing services sectors in the world, second only to China; the sector grew at an average annual rate of 9% between 2001 and 2012.

FIGURE 2: EVOLUTION OF SECTOR CONTRIBUTION TO GDP (% OF GDP PPP, INTERNATIONAL DOLLAR BILLIONS)



Source: World Development Indicators, The World Bank; IMF World Economic Outlook Database 2014

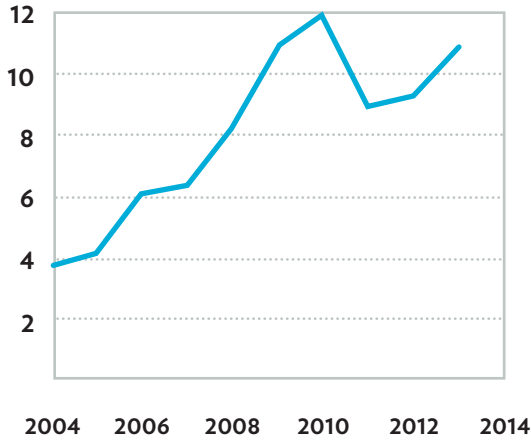
Economists have suggested that India is experiencing a temporary “stagflation,” posing challenges to growth.¹³² Stagflation refers to a situation of slow growth and high inflation, which India has been facing over the past few years. In addition, the fiscal deficit has increased since 2008, as seen in Figure 3. In light of these developments, the Reserve Bank of India (RBI), has raised interest rates and considered an inflation target to curb inflation, which hovered around 11% in 2013, but has fallen slightly recently. Moreover, the government has stated an aim to bring the fiscal deficit down to 4.1% in 2014. However, Fitch, Moody's, and Standard & Poor's have stated that they are not convinced that this is a realistic target.¹³³ All in all, an improvement of macroeconomic fundamentals is a key requirement for sustaining and improving investor sentiment and the momentum of FDI inflows into India.

¹³² “India in stagflation, not crisis,” *Economic Times*, December 22, 2013.

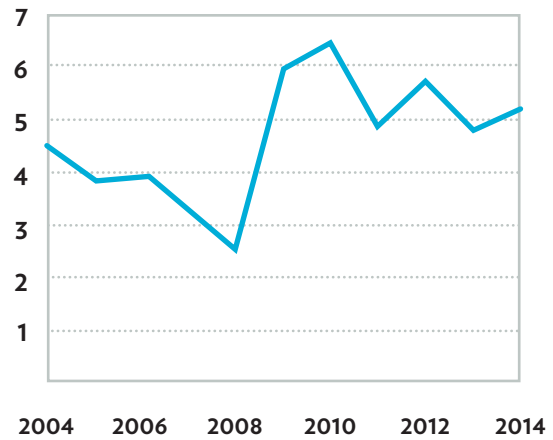
¹³³ “Finance secretary Mayaram defends 4.1 percent fiscal deficit target,” *Reuters*, July 12, 2014.

FIGURE 3: INFLATION RATE, CONSUMER PRICE INDEX (CPI) AND FISCAL DEFICIT (% OF GDP)

INFLATION RATE,
CONSUMER PRICE INDEX (CPI)
(ANNUAL, %)



FISCAL DEFICIT
(% OF GDP)



Sources: World Development Indicators, The World Bank; Planning Commission of India

After a surge in the early and mid-2000s, India has seen unusually volatile FDI flows, caused largely by regulatory uncertainty and the global financial crisis.

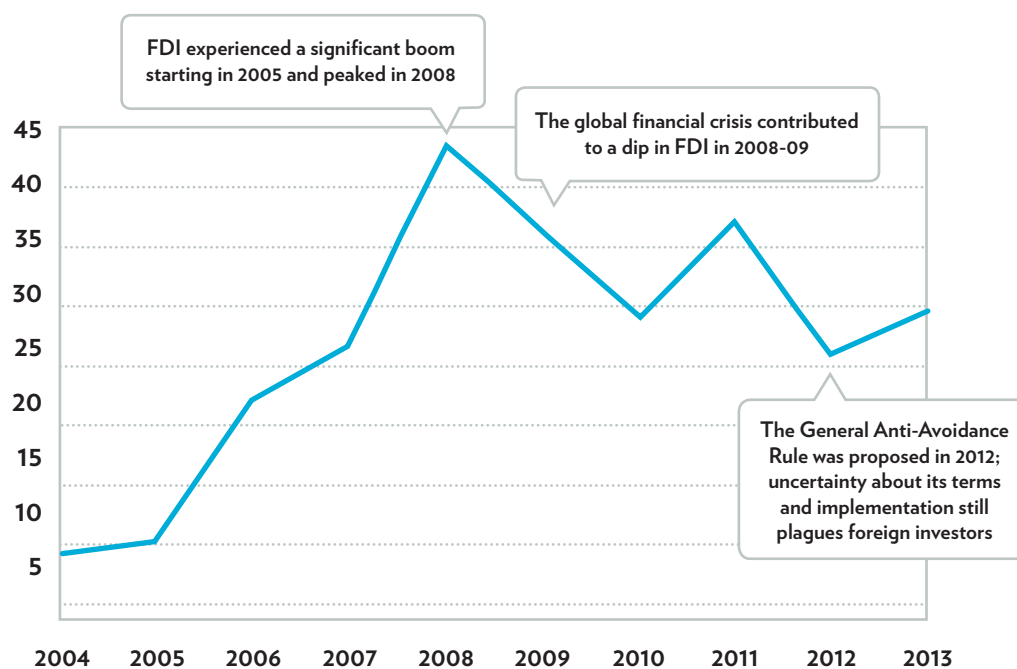
Mirroring India’s emergence as a rapidly growing economy, investor sentiment and FDI inflows grew rapidly in the 2000s, peaking in 2008 at USD 43.4 billion (see Figure 4). However, regulations such as the General Anti-Avoidance Rules¹³⁴ (GAAR) and frequently changing tax laws have led to uncertainties in the regulatory environment. This has augmented foreign investors’ perception of the risk of investing in India, and has led to lower inflows. This is reflected in India’s low score of 3/6 on the World Bank’s Country Policy and Institutional Assessment (CPIA).¹³⁵

Further, negative global forces such as the global financial crisis and the Eurozone debt crisis have reduced FDI inflows. In the short-to-medium term, the growth of FDI inflows will hinge on the creation of an investor-friendly environment, as the global economy recovers. There are initial signs of investor confidence improving slightly, but sustained improvement is required to revert to earlier levels.

¹³⁴ In Indian law, the General Anti-Avoidance Rules are a set of rules designed to minimize tax avoidance, for example by siphoning off profits to tax havens. They are due to be implemented in April 2015.

¹³⁵ The CPIA Business Regulatory Environment scale of the World Bank, assesses the extent to which the legal, regulatory, and policy environments help or hinder private businesses in investing, creating jobs, and becoming more productive.

FIGURE 4: FOREIGN DIRECT INVESTMENT (FDI) NET INFLOWS (2004-2013), CURRENT USD BILLIONS



Sources: World Development Indicators, The World Bank

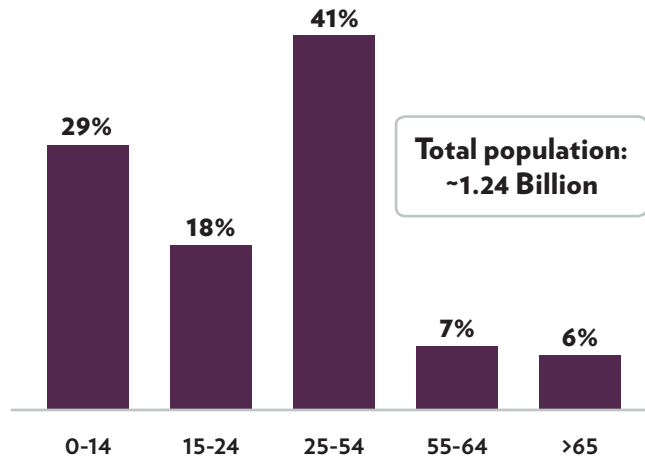
Key constraints in India

With 47% of its population under the age of 25, India can leverage its demographic dividend to great effect if it can overcome key challenges. However, skill deficits and a low-quality higher education system remain a key constraint to India achieving this potential. In a recent report, the IMF argues that a large part of India's growth acceleration since the 1980s is attributable to changes in the country's age structure. Building on this, they estimate that India's young population has the potential to produce an additional 2% per capita GDP growth each year for the next two decades.¹³⁶ Such a high potential for acceleration can further attract foreign investors to look for investment opportunities in India. Unfortunately, however, 16.3% of urban males who were at least college graduates in the age group of up to 29 years were unemployed in 2011-12; the overall unemployment rate for males is 3% and for females is 5%.¹³⁷ Moreover, India's expansive population dilutes the positive effects of growth. The average Indian is considered to be of lower-middle income status by the World Bank with a per capita PPP GDP at USD 5,410. If India can effectively absorb the added labor force, then there is likely to be a significant push to growth.

¹³⁶ "The demographic dividend: Evidence from the Indian states," IMF, 2011.

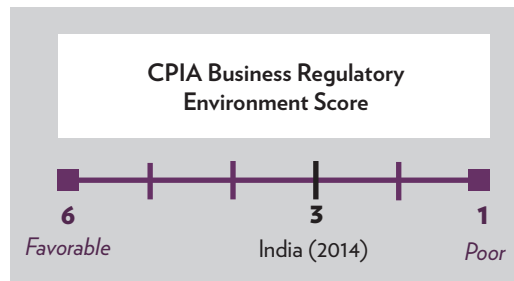
¹³⁷ National Sample Survey, India.

FIGURE 5: POPULATION AGE DISTRIBUTION (% OF POPULATION, 2014)



Source: CIA World Factbook

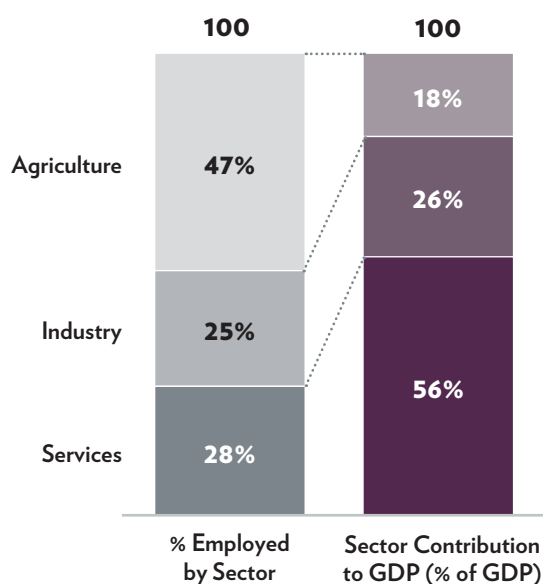
Although India’s high growth has reduced poverty levels, concerns remain around income inequality, regional disparities, and gender inequality. As of 2010, nearly a quarter of the population was below the poverty line of international USD 2 a day (PPP).¹³⁸ This is a five percentage point improvement over 2005. However, large disparities remain across states. Over 50% of the population of Bihar was below the domestic poverty line. In contrast, the figure for Kerala was 12%. Income inequality is quite high and has increased since the beginning of the liberalization era in the 1980s: the Gini coefficient rose to 0.34 in 2010 from 0.31 in 1983.¹³⁹ As seen in Figure 6, the contribution to GDP and the labor force employed by sectors are widely disproportionate. In 2012, services contributed to more than half the GDP but employed just over a quarter of the labor force. In contrast, agriculture employed nearly half of the labor force but contributed less than a fifth of the GDP. Moreover, India ranks 101 out of 136 countries for gender equality, the lowest of the BRICS economies. This is due to its poor performance on measures of health, education, and economic participation and equality for women.



¹³⁸ Using the World Bank methodology.

¹³⁹ The Gini coefficient (also known as the Gini index or Gini ratio) is a measure of statistical dispersion intended to represent the income distribution of a country. A higher co-efficient represents greater inequality.

FIGURE 6: CONTRIBUTION TO GDP AND LABOR FORCE EMPLOYED BY SECTOR (2012, %)



Source: World Development Indicators, The World Bank

Despite its rapid growth, India has lagged behind many emerging economies in ensuring a decent standard of living for its population. India is ranked 135th in the world on the Human Development Index (HDI), and is significantly below the BRICS average score, as seen in Figure 7. According to the 2014 UNDP Human Development Report, life expectancy at birth is at 66.4 years. This is up 11 years from 1983 but is still lower than in all BRICS countries, except South Africa. Further, healthcare provision is inadequate to meet demand: as of 2011, there were 0.7 hospital beds and 0.63 doctors per 1000 people in India,¹⁴⁰ compared with 2.3 in Brazil, 3.8 in China, 3.6 in Sri Lanka, and 2.5 in Turkey, for example.

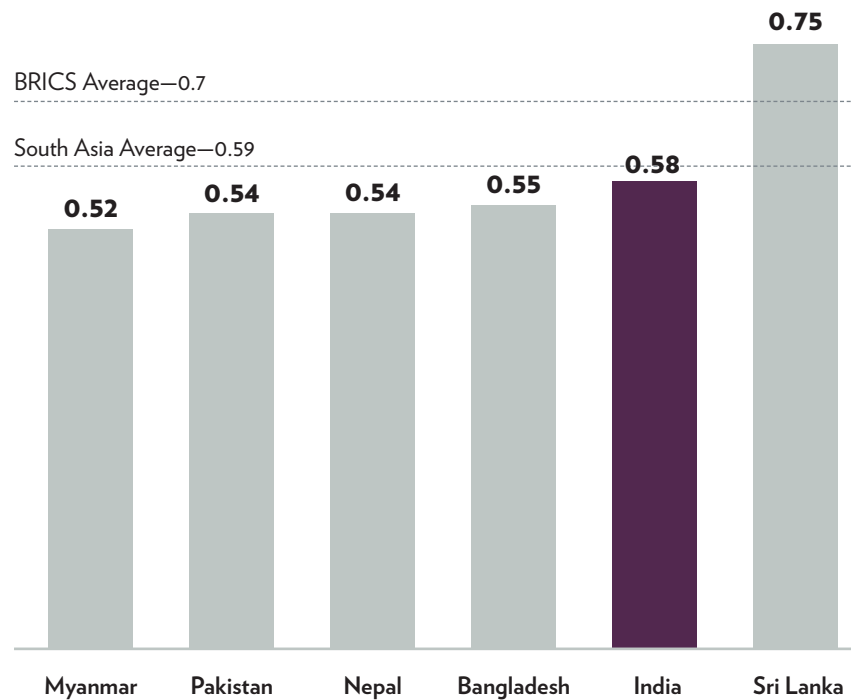
India also lags behind the other BRICS countries on measures of education and literacy. The mean number of years of schooling in India is 4.43 years, which is up by 2.5 years since 1980, but lower than that of all BRICS countries. Although the rate of school attendance is improving for primary and secondary schools, the education system remains inadequately developed due to a shortage of infrastructure, finances, and quality staff. Currently, the Indian government has focused on achieving the universalization of primary education through its “Sarva Shiksha Abhiyan,” i.e., the Education for All Movement. This program was launched in 2001 and made education free and compulsory to children between six and 14 years of age.

Sanitation has also remained a key problem in India. The WHO/UNICEF Joint Monitoring Program (JMP) for Water Supply and Sanitation estimates that only

¹⁴⁰World Health Organization, 2011.

25% of the rural population has access to improved sanitation facilities;¹⁴¹ the corresponding figure for urban India is 60%. For India as a whole, this figure has doubled from 18% in 1990 to 36% in 2012, but this is still not on track to meet the country's Millennium Development Goal (MDG) target. In addition, of India's 700,000 rural schools, only one-sixth have toilets, deterring girls from attending school.

FIGURE 7: HUMAN DEVELOPMENT INDEX (HDI) SCORE FOR THE SOUTH ASIAN COUNTRIES UNDER STUDY (0 TO 1)



Source: UNDP Human Development Report, 2014

¹⁴¹ For Millennium Development Goals (MDG) monitoring, an improved sanitation facility is defined as one that "hygienically separates human excreta from human contact" by WHO/UNICEF Joint Monitoring Program (JMP) for Water Supply and Sanitation.

INVESTING IN INDIA: THE SUPPLY SIDE

Overview of impact investing in India

The impact investing space in India is robust and continuing to grow; it represents the largest impact investment market in South Asia. DFIs have deployed close to USD 5 billion in direct investments in India to date, while other impact investors have deployed USD 438 million. In addition to this, approximately USD 2.6 billion has been channeled by DFIs through fund managers as indirect investments; however, we refrain from using these indirect investments in our calculation of overall totals in order to avoid possible double counting of investments.¹⁴² A majority (greater than 90%) of both direct and indirect investments in India is made by development finance institutions (DFIs), suggesting that their investing behavior largely drives trends within the overall investment space; however, a large number of impact investment funds are also making a mark, independent of DFIs.

A relatively large domestic impact enterprise¹⁴³ market, the emergence of several exits from investments made in the mid-2000s, and the perceived strong return potential make India an attractive market for impact investors. As a result, the impact investing market in India is expected to grow further. Regulatory considerations are not a significant barrier for foreign or domestic players to enter the market, despite posing specific challenges in raising and deploying capital or structuring deals. Conventional investors often participate alongside impact investors in many deals, increasing competition and sometimes cooperation between investor segments.

A range of foreign and domestic players have deployed capital in the Indian impact investing market. Figure 8 provides an overview of the actors in this space.

FIGURE 8: OVERVIEW OF IMPACT INVESTORS IN INDIA

TYPE OF INVESTOR	ESTIMATED NUMBER OR RANGE	EXAMPLES
Fund Managers	>50	<ul style="list-style-type: none"> • Aavishkaar • Acumen Fund • Elevar (Unitus Equity) • Khosla Impact • Lok Capital • LGTVP • responsAbility • Sangam
Development Finance Institutions	10-12	<ul style="list-style-type: none"> • ADB • CDC • DEG • FMO • IFC • KfW • OPIC • Proparco • SIDBI/NABARD
Foundations, HNWLs, and Family Offices	10-12	<ul style="list-style-type: none"> • Michael and Susan Dell Foundation • Omidyar Network

¹⁴² The share of the indirect investments already included in the direct investment total is not known.

¹⁴³ Impact enterprises for the purposes of this report are defined as those that have articulated a core objective to generate positive social or environmental impact (i.e. as a part of their operating model rather than an ancillary activity as with CSR programs); and seek to grow to financial viability and sustainability.

Although both foreign and domestic impact funds are active in India, the majority are based offshore due to more favorable regulations. Of the total of about 50 prominent impact investment funds active in India, our estimate is that approximately 80% are based outside the country, to avoid issues related to taxation and repatriation. An increase in domestic funds is expected in the future, as local investors gain confidence in impact investing.

In the past 7-10 years, DFIs have invested over USD 7.5 billion into India, combining both direct and indirect investments. Approximately USD 5 billion has been invested directly into enterprises, while approximately USD 2.6 billion has been invested into funds. (The impact capital invested into funds has not been included in our overall calculations to avoid double counting of fund investments into enterprises as well as the possibility of including capital that has been yet to be deployed by these funds.)

Foundations are initiating impact investments in India; high net-worth individuals (HNWIs) and family offices are a critical source of seed-stage funds in impact-related investments (though they may lack intention or measurement). Until recently, foundations largely only engaged in grant provision to NGOs and non-profits in India. Domestic foundations currently offer modest amounts of investment and focus on technical assistance and supportive networks for small or medium enterprises (SMEs) in India. International foundations tend to function as catalysts in specific sectors, aiming to encourage additional commercial capital in areas where investors are otherwise reluctant to invest, such as in education in India. Foundations tend to have significantly lower set expectations for returns, or sometimes none.

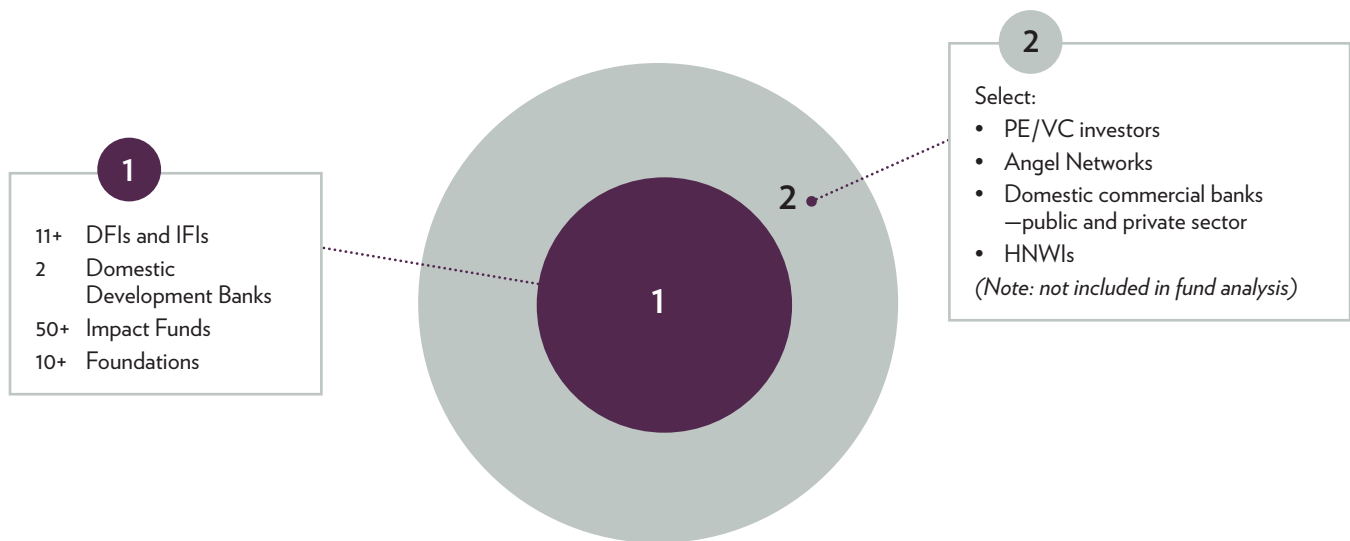
Individual investors are a predominant source of seed funding; however they are primarily driven by commercial returns. Furthermore, these investors are largely connected to enterprises through family and friend networks. Well-established angel networks, such as the Intelicap Impact Investment Network (IIN), Mumbai Angels, and the Indian Angels Network, are engaging further and more formally in impact investments, providing greater access to enterprises seeking access to seed funding.

Large business conglomerates may contribute to the pool of domestic funds for impact investment in the future; however, they are currently engaging in philanthropic efforts or purely commercially oriented investments.

Public sector banks are involved in SME financing. They are mandated to lend into government-determined priority sectors, including agriculture, education, and housing. On the other hand, they are wary of entering sectors deemed as new or uncertain, including renewable energy, water, and sanitation.

India houses the largest number of impact investors in the region. For the purposes of this study, due to the size of the Indian market and the difficulty of quantifying capital deployed by impact-related investors, the following analysis focuses only on impact investors (Ring 1 in Figure 9). As seen in Figure 9, there exists a minimum of 75 impact investors active in India.

FIGURE 9: NUMBER OF DIRECT IMPACT AND IMPACT-RELATED INVESTORS ACTIVE IN INDIA¹⁶



Source: Stakeholder interviews; Investor websites; Dalberg analysis

The total known impact capital deployed by DFIs directly into enterprises is approximately USD 5 billion. A further USD 437 million has been deployed by other impact investors. These figures quantify capital from over 300 deals.¹⁴⁵

RECENT STUDIES ON IMPACT INVESTING IN INDIA

The 2014 Intellectap Impact Investing Report: *“Invest. Catalyze. Mainstream. The Indian Impact Investing Story,”* is a recent assessment of the impact investing space in India produced by Intellectap and funded by GIZ. The report analyzes a total of USD 1.6 billion invested by impact investors in over 220 enterprises. The report focuses on the “venture approach” to investing. The higher estimate of invested impact capital in this study is primarily driven by the inclusion of all investments made by impact investors, as well as an enumeration of debt investments. The Intellectap report plays a prominent role in heightening our understanding of challenges and directions of impact investing in India.

The 2013 Unitus Capital India Impact Equity Investment Report: Unitus Capital aims to release regular reports to capture annual impact equity investing in India. Unitus Capital estimates that, in 2013, approximately USD 390 million was invested through impact private equity transactions. Yearly assessments of transactions and key trends provide the opportunity for almost real-time understanding and projections of future activity in the impact investing space.

The 2013 Unitus Seed Fund Impact Investing Report: In 2013, the Unitus Seed Fund published *“Impact Investing Reaches a Tipping Point in India,”* which provides a landscape overview of the history and relevance of impact investing in the context of economic development in India.

¹⁴⁴ See “Defining key terms and concepts” in the introduction chapter of this report for an explanation of the framework used for categorizing investors using a two-ring framework, where the inner ring—Ring 1—represents the impact investing activity and the outer ring—Ring 2—represents the activity related to impact investing but lacking either an explicit impact intention or measurement.

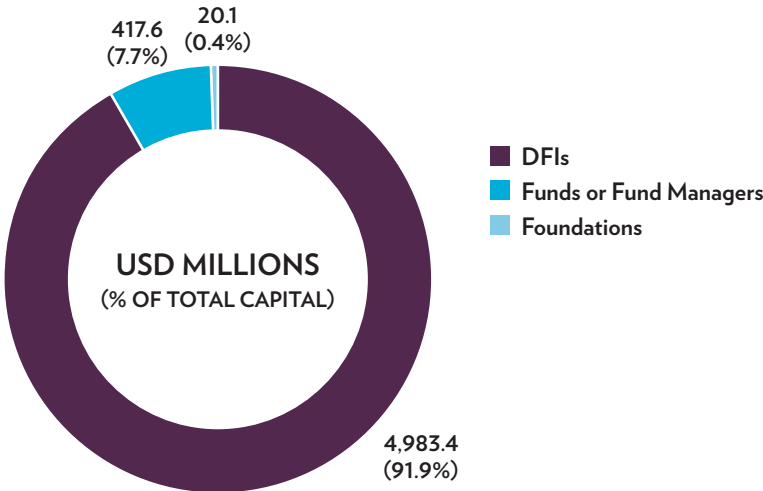
¹⁴⁵ While approximately 100 additional deals have been captured in our database, the value for these deals are undisclosed; however, the majority of these undisclosed deals are between funds and enterprises, and therefore have relatively low investment sizes in comparison to DFI deals.

Key trends of impact investing in India

INVESTOR MIX

DFIs represent the largest share of capital deployed at USD 5 billion. Known investments from impact investment funds total approximately USD 418 million (Figure 10). Our analysis suggests that at least 40% of fund deals are undisclosed, indicating that the total for fund direct investments could be as high as USD 700 million. Foundations, in addition, are mostly new actors in the impact investment space in India, and have deployed approximately USD 20 million to date. Of all known direct investments, DFI investments account for about 92%, while fund investments represent about 8%. Less than 1% of current investments originate from foundations; however, foundations exhibit a growing interest to make impact investments in addition to grants in the future.

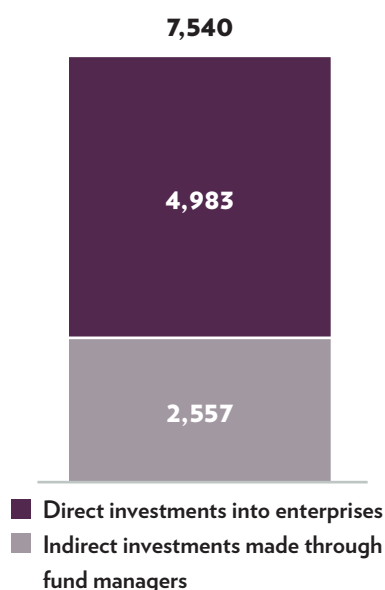
FIGURE 10: TOTAL IMPACT CAPITAL (DIRECT INVESTMENTS) DEPLOYED BY INVESTOR TYPE



Source: Stakeholder interviews; Investor websites; Dalberg analysis

An additional USD 2.6 billion from DFIs has been channeled through investment funds. This represents a sizeable additional investment to those that DFIs made directly into enterprises. An unknown percentage of this capital may have been captured in the previous total of direct investments from funds to enterprises (USD 418 million). While this USD 2.6 billion is not included in our estimation of the total impact capital in India, in order to avoid double counting, our estimate is that a portion of this contributes to an additional amount of capital overall.

FIGURE 11: TOTAL DFI DIRECT AND INDIRECT INVESTMENTS, USD MILLIONS



Source: Stakeholder interviews; Investor websites; Dalberg analysis

Outside the realm of impact investing as defined in this study, DFIs also contribute a significant amount of funding directly to the Indian government as public sector investments for large-scale programs in infrastructure and energy. Investments from two DFIs alone—Asian Development Bank and KfW (the German development bank)—in the past 5 years total approximately USD 5 billion into state- and national-level programming.

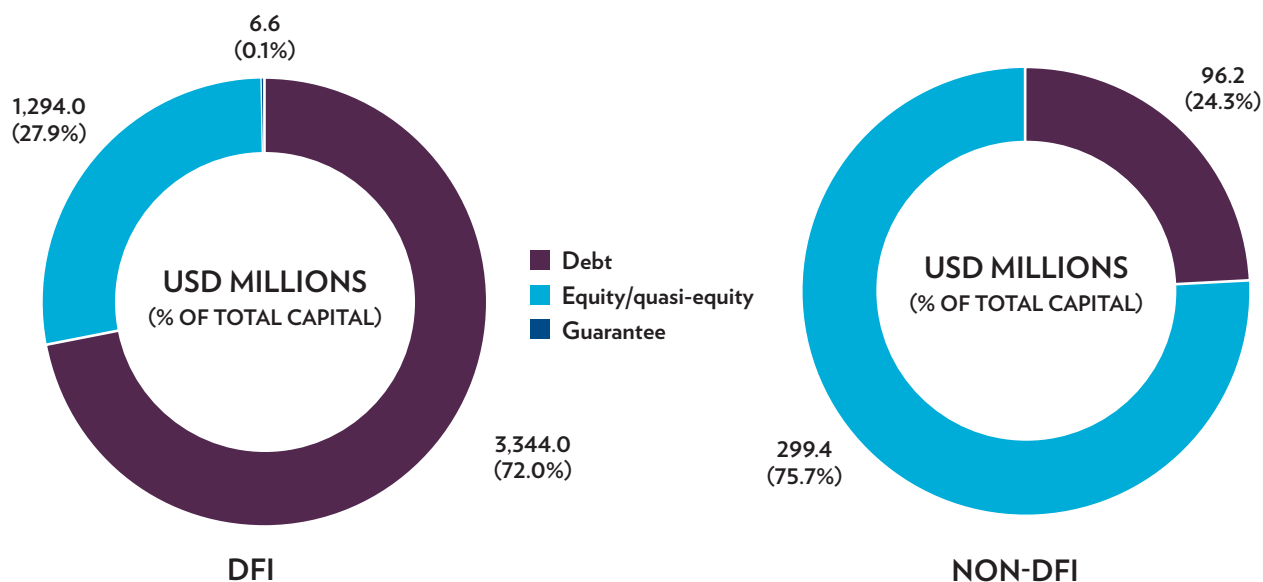
INSTRUMENT

Approximately 68% of the total known impact capital deployed to date in the Indian market has been invested as debt; this trend is largely driven by DFIs. With the DFI percentage of overall impact capital at approximately 92%, DFI preference for debt financing drives the overall trend in instrument use. When looking at DFI investments alone, the percentage of known investments in debt is 72% and that in equity or quasi-equity is 28%. DFIs have historically tended to engage primarily in large debt deals, citing this as a lower-risk way to engage in a particular market. However, anecdotally, DFIs indicate that they do have a growing interest in equity investments, motivated by a desire to establish deeper and longer-term partnerships with their investees. The debt/equity split for a DFI could be closer to 60/40 in the next five to ten years.

Among non-DFI investments in India, 76% of known investments are in equity or quasi-equity products, while only 24% are debt. There exists a strong preference for equity among non-DFI investors. Impact funds tend to be engaged in either all debt or all equity, and only engage in a mix of investment types in cases where equity funds agree to provide debt to an existing investee as part of a follow-on round of funding. Foundations that are beginning to initiate impact investments primarily

engage in equity (approximately 90% of the known investment sample of USD 8.77 million¹⁴⁶). The preference for equity indicates a willingness and desire for non-DFI investors to provide in-depth organizational support and take on a greater role within investee organizations. However, it also suggests a serious gap in debt financing for investees, which will be discussed later in this report.

FIGURE 12: IMPACT CAPITAL BY INSTRUMENT



Sources: Stakeholder interviews; Investor websites; Dalberg analysis. Note: Unknown amount (DFI: USD 338.9 million, Non-DFI: USD 42.1 million) not included in the graphs

Regulations prohibit most foreign providers of capital from engaging in debt transactions.

Another reason for the high percentage of equity investments among non-DFI investors is the regulation against debt provision for non-domestic investors. The Securities and Exchange Board of India (SEBI) regulations do not allow foreign investors to engage in debt transactions unless they are registered as a Foreign Portfolio Investor (FPI), a designation for which not all funds qualify. (DFIs are regulated as “internationally recognized sources” and thus are able to use debt.)¹⁴⁷ Investors often prefer to set up foreign entities, in Mauritius or Singapore for example, because of favorable tax structures, seamless repatriation, and a more conducive legal environment. As a result, given that most of the impact capital in India is invested through foreign entities, many are not eligible to provide debt.

Apart from a few quasi-equity instruments, structured as convertible debt, few

¹⁴⁶ The remaining USD 11.4 million investments from foundations are unknown in terms of instrument.

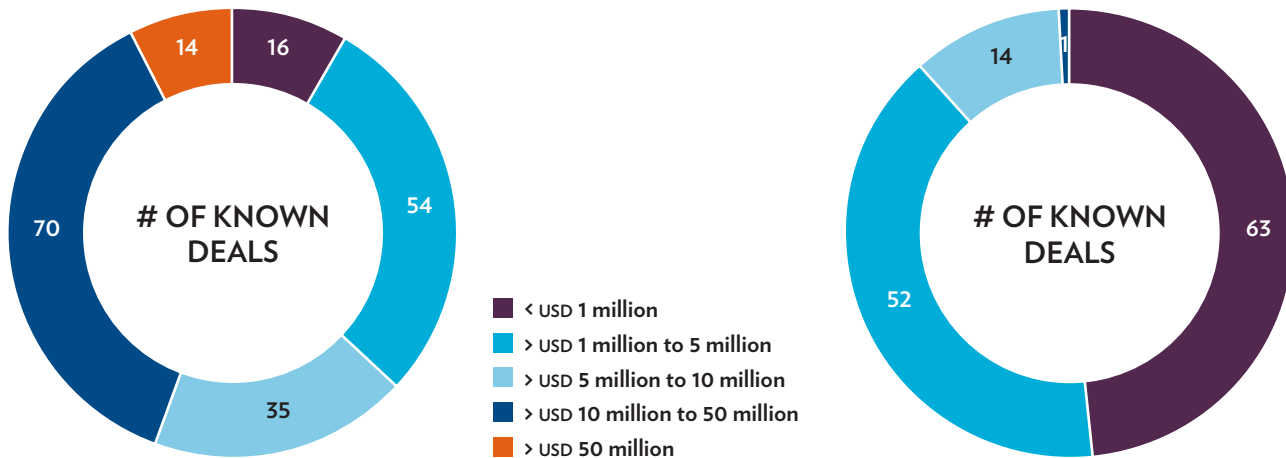
¹⁴⁷ The Reserve Bank of India master circular from July 2014 clarifies that borrowers can raise external commercial borrowings from “internationally recognized sources” (which include multilateral financial institutions). View the circular at http://www.rbi.org.in/scripts/BS_ViewMasCircularDetails.aspx?id=9069.

innovative investment instruments exist in the market. The presence of innovative financing instruments is yet to be seen in the Indian impact investment market. Social impact bonds (SIBs), which operate on a pay-for-success model, present a great amount of potential for the future of impact investing. Educate Girls was the first Indian organization to receive support through a pay for results program that pays for outcomes, rather than outputs, of an enterprise’s activities. While outcomes in the development sector are rather difficult to quantify, the increasing interest in pay-for-performance models presents SIBs as a potentially relevant option for the future.

GROWTH STAGE AND DEAL SIZE

As expected, given the large number of impact investment deals in the Indian market in comparison to other South Asian countries, we see a spread across a range of deal sizes. With exceptions, DFIs engage in deal sizes up to USD 50 million, with an average deal size of USD 25 million. DFI deals can range from as small as USD 25,000 to deals in the hundreds of millions of dollars, suggesting varied investment behaviors and trends. Most non-DFI investors engage in deal sizes up to USD 10 million, with an average deal size of USD 3 million, including both first round and follow-on investments. Figure 13 provides an overview of the distribution in deal sizes for all impact investors in India.

FIGURE 13: IMPACT CAPITAL BY DEAL SIZE



Sources: Stakeholder interviews; Investor websites; Dalberg analysis. Note: Unknown deals not included in the graphs.

Given co-investments in deals between DFIs, non-DFI impact investors, and conventional investors, deal sizes do not always correspond to growth stage. On the whole, impact funds and foundations engage mostly with seed-, venture-, and growth-stage organizations while DFIs prefer to engage with growth-stage and mature companies. Mature companies have naturally absorbed the greatest amount of impact capital, given their relatively large individual deal sizes. Of the known investments in this analysis, the number of deals under USD 5 million represents more than 50% of the total number of known deals in the sample. However, despite this figure, investors do not perceive that access to capital for enterprises at the seed and venture stages is sufficient in the Indian market.

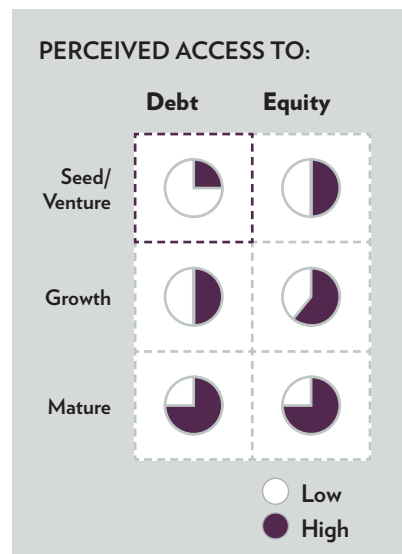
Overall, investors indicate reluctance to engage with seed- and venture-stage enterprises, given that there is not yet enough confidence in the financial viability of investing at these early stages. As a result, growth-stage and mature enterprises enjoy access to capital, and there exists a clear gap in the market for investments into seed- and venture-stage organizations that find it difficult to prove their business models.

Furthermore, given that non-DFI investors are the ones with the bandwidth and ability to provide smaller investments to younger organizations, and that they are most interested in equity investments, there is a further challenge for seed- and venture-stage organizations to access debt. Without sufficient domestic impact investment funds that can provide debt capital at small ticket sizes, access to working capital loans for small and young enterprises is difficult and is one of the biggest challenges in the impact investment market in India.

SECTOR

The majority of investments by impact funds have been made in the financial services sector, primarily in microfinance institutions (MFIs). According to a recent Intellectap report, the largest percentage of investments into impact enterprises have been in the financial inclusion sector (into both MFIs and non-MFI enterprises) at 70%. Furthermore, within the financial inclusion sector, the share of capital invested in MFIs is 77%.¹⁴⁸

Almost all fund managers either have funds specifically focused on financial inclusion, or have made most of their initial investments in financial services organizations. Even for DFIs, who tend to have a diversified portfolio, the financial services sector tends to be a top sector destination.



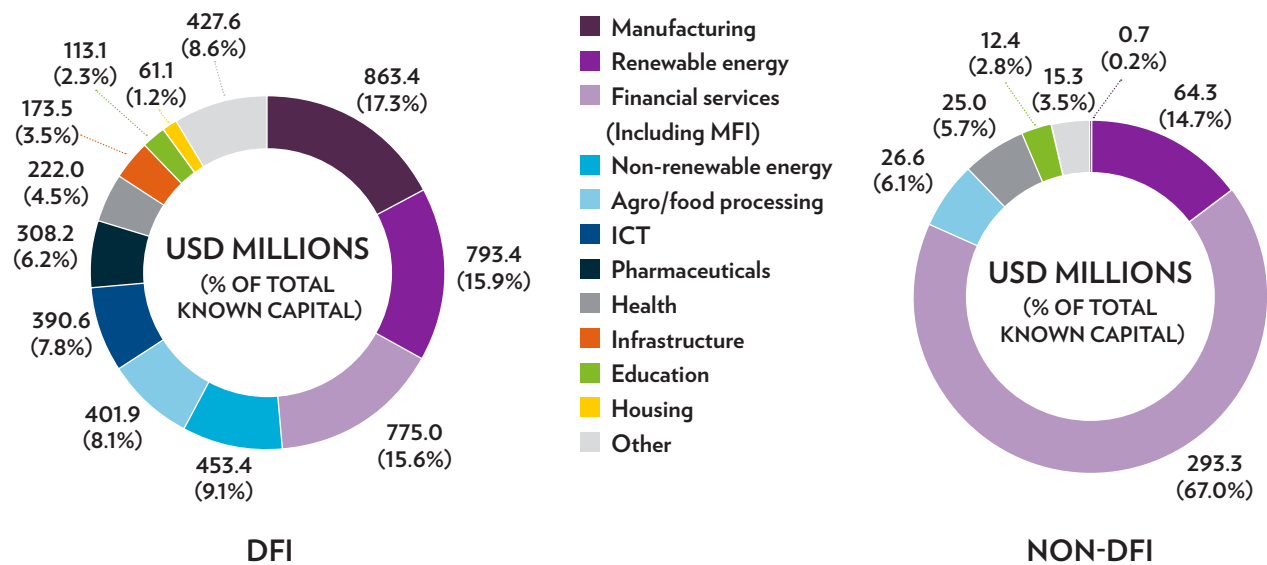
The degree of impact as a result of investing in microfinance is a topic of

¹⁴⁸ "Invest. Catalyze. Mainstream: The Indian impact investing story," Intellectap, 2014.

continued debate. Some stakeholders do not believe that simply lending money to low-income populations is impactful. Others contend that access to finance is a critical pillar of economic development, and that financial exclusion is emblematic of the broader exclusion of low-income populations from economic systems. The relationship between financial returns and social impact in an investment will be discussed later in this report. The high percentage of investments in financial inclusion, and further in microfinance, is driven by the high expected rate of returns, and oftentimes a lack of sector-specific expertise in other sectors.

The sectors receiving the most impact capital are manufacturing, energy (renewable and non-renewable), financial services, and agri-business. As seen in Figure 14, DFI investors have invested 17.3% in manufacturing, 15.9% in renewable energy, 15.6% in financial services (including microfinance), 9.1% in non-renewable energy, and 8.1% in agriculture and food processing. On the other hand, two-thirds of capital deployed to date by non-DFI investors has been into the financial services sector (including microfinance). Non-DFI players have invested approximately 14.7% of total known impact capital into the manufacturing sector. Agriculture/food processing companies and enterprises in healthcare have received close to 6% each.

FIGURE 14: IMPACT CAPITAL BY SECTOR



Sources: Stakeholder interviews; Investor websites; Dalberg analysis.

Two key trends among impact investors in India are a movement from an opportunistic selection approach to a hypothesis-driven one, and as a result, an increase in the presence of sector-specific funds. To date, investments across the board have been largely opportunistic: impact funds have often chosen portfolio companies from the many that reach out to them directly to seek funding. However, now, impact investors are eager to take on a more proactive approach when selecting investees. Investors wish to be more deliberate in identifying a sector focus, a key problem area that they wish to address, and, even further, a hypothesized mechanism through which to address this problem. With a clear problem and potential solution in mind, they seek organizations that provide this particular solution. Along these lines, while traditionally impact investment funds have been generalist funds focusing primarily on financial inclusion with limited expertise in other sectors, we are now starting to see sector-specific funds take prominence. These impact funds have a more narrow focus in their selection of investees, and provide the added value of specific, technical expertise and content experience.

Exit possibilities

As noted above, investors are beginning to diversify the sectors in which they invest. Contributing to this shift are the dual factors of the microfinance crisis in 2010 and a few successful exits in microfinance that have freed up capital. Investors are confident in possibilities for sustainable exit models over the next five years, while acknowledging that India's impact investing market is still in early stages in sectors outside of financial services. While most of the early investments have been in financial services (particularly microfinance), investors are now showing a greater inclination to make investments in other sectors. In particular, the sectors that investors identify as being most attractive in the near future include energy, education, water and sanitation, and technology-based solutions across sectors. There is also interest in agri-business, healthcare, and manufacturing.

There have been at least 17 profitable exits by impact investors, boosting investor confidence and signaling that the industry can generate strong returns. These profitable exits have been critical in building industry confidence, providing a push to further capital flow into impact enterprises. Over half of these exits have been in the MFI sector, while livelihoods,¹⁴⁹ renewable energy and agri-business have seen some exits more recently. For example, 2014 saw Lok Capital's exit from Rural Shores, a rural business process outsourcing center, and Aavishkaar's exit from Milk Mantra, an agri-business company. While there have been a few losses made on exits as well, investor perceptions are largely positive.

INVESTOR	ENTERPRISE	SECTOR	YEAR	EXIT MODE
Unitus Equity Fund	SKS Microfinance	MFI	2010	IPO
Aavishkaar	Rangsutra	Handicrafts	2012	Trade Sale
Aavishkaar	Naveen Gram	Agri-business	2012	Buyback
Aavishkaar	Tide Technocrats	Consulting services	2012	Buyback
Lok Capital	Satin Creditcare	MFI	2013	Trade Sale
Aavishkaar	Milk Mantra	Agri-business	2014	Trade Sale
Lok Capital	Rural Shores	Rural business process outsourcing center	2014	Trade Sale

¹⁴⁹ While "livelihoods" is strictly not a sector, the term broadly refers to a set of businesses which help provide employment or generate livelihoods.

Impact measurement

A debate between the tradeoff, or lack thereof, between financial returns and social impact is the driving reason for erratic impact metrics among impact investors in India. Several players in the market contend that a tradeoff always exists between an enterprise generating a profit and creating social impact. Investors who hold this view, typically foundations or others who self-characterize as “impact first,” are more conscious about putting impact metrics in place. These metrics will be discussed subsequently.

Conversely, a growing set of impact funds and enterprises believe that there is no tradeoff, and that financial returns and social impact are positively linked. For some of these funds, the same metrics can be tracked, by definition, to measure performance on both the financial and non-financial sides. Investors in this scenario believe that the due diligence process is sufficient for understanding whether the enterprise’s business model will create impact; social impact, therefore, is assumed to be reflected in financial indicators and hence the design of separate social impact metrics is not prioritized. Enterprises that hold this view tend to be those who focus on income generation for the base-of-pyramid (BoP) population, rather than organizations whose aim is to increase affordability of certain goods or services.

It is difficult to generalize the presence of these views in any specific sector or enterprise or investor group. However, investors and enterprises that have a similar set of beliefs on measurement tend to align and move forward with investment deals.

While by definition all impact investors express impact intent and attempt to measure social impact, investors often do not design impact metrics at launch, and metrics vary by investor. Given the time and resources invested in the selection and due diligence process, putting into place methods for impact measurement typically falls secondary to managing the investment itself; as a result, metrics are often still being developed much after the launch of a fund or finalization of a deal. Furthermore, several impact investors that act as limited partners do not have standardized indicators for measuring impact, and allow individual fund managers into which they invest, or even investment managers within those organizations, to determine the metrics used to measure success for an investee.

Investors measure social impact using both quantitative metrics and anecdotal assessments. Key outcome indicators tend to be developed on the basis of the assumption that economic impact will have social benefits, and common metrics include number of jobs created by the enterprise, amount of income generated for beneficiary families, and number of products sold to the BoP population. These metrics are typically in addition to a measurement of the overall reach of the business, including the number of families engaged in the organization’s activities or, more specifically, the number of women engaged. Most impact investors also supplement these metrics with anecdotal assessments (in some cases, for smaller or newer funds, anecdotal impact assessment comes first, before more rigorous measurement tools are in place). In this case, investors aim to capture stories of individuals and families that have been supported by the investment. Another approach is to capture the indirect impact on the investee or industry through knowledge creation and public visibility for a specific problem or solution.

Although investors and enterprises are aware of formal, standardized measurement tools, the use of these is not widespread. Global and national initiatives towards standardization of metrics used in impact investing include IRIS,¹⁵⁰ Global Impact Investment Rating System (GIIRS), and Portfolio Risk, Impact, and Sustainability Measurement (PRISM). IRIS, managed by the GIIN, is a catalog of standardized metrics to measure social, environmental, and financial performance that can be tailored by impact investors to measure performance of their investments and to increase credibility within the industry. GIIRS, managed by B Lab, uses a rating system to assess the social and environmental performance of companies and investors but does not incorporate financial performance. PRISM, launched in 2014 by Intellectap, is a rating and reporting framework specifically designed to measure the impact of investments in the Indian context and is also applicable to other emerging markets. Whereas IRIS is a set of metrics, GIIRS and PRISM are ratings systems that assign values and weights to an organization's performance on metrics. Both GIIRS and PRISM use IRIS metrics in their assessment questions where possible. Furthermore, the Indian Impact Investment Council (IIC), which will be discussed subsequently, has come together with a mission to infuse standardization in the Indian impact investing market.

Despite these available resources and tools for standardization, many impact investors have not established a standardized mechanism and a set of metrics to measure impact across investees or even investee types; they pursue impact measurement on a case-by-case basis, working with the entrepreneur to determine metrics that make sense. For impact funds where a DFI acts as the limited partner, metric-based reporting is more closely followed, including compliance with environmental, social, and governance standards.

¹⁵⁰ IRIS (formerly known as *Impact Reporting and Investment Standards*) is a set of standardized metrics for impact measurement managed by the Global Impact Investment Network (iris.thegiin.org).

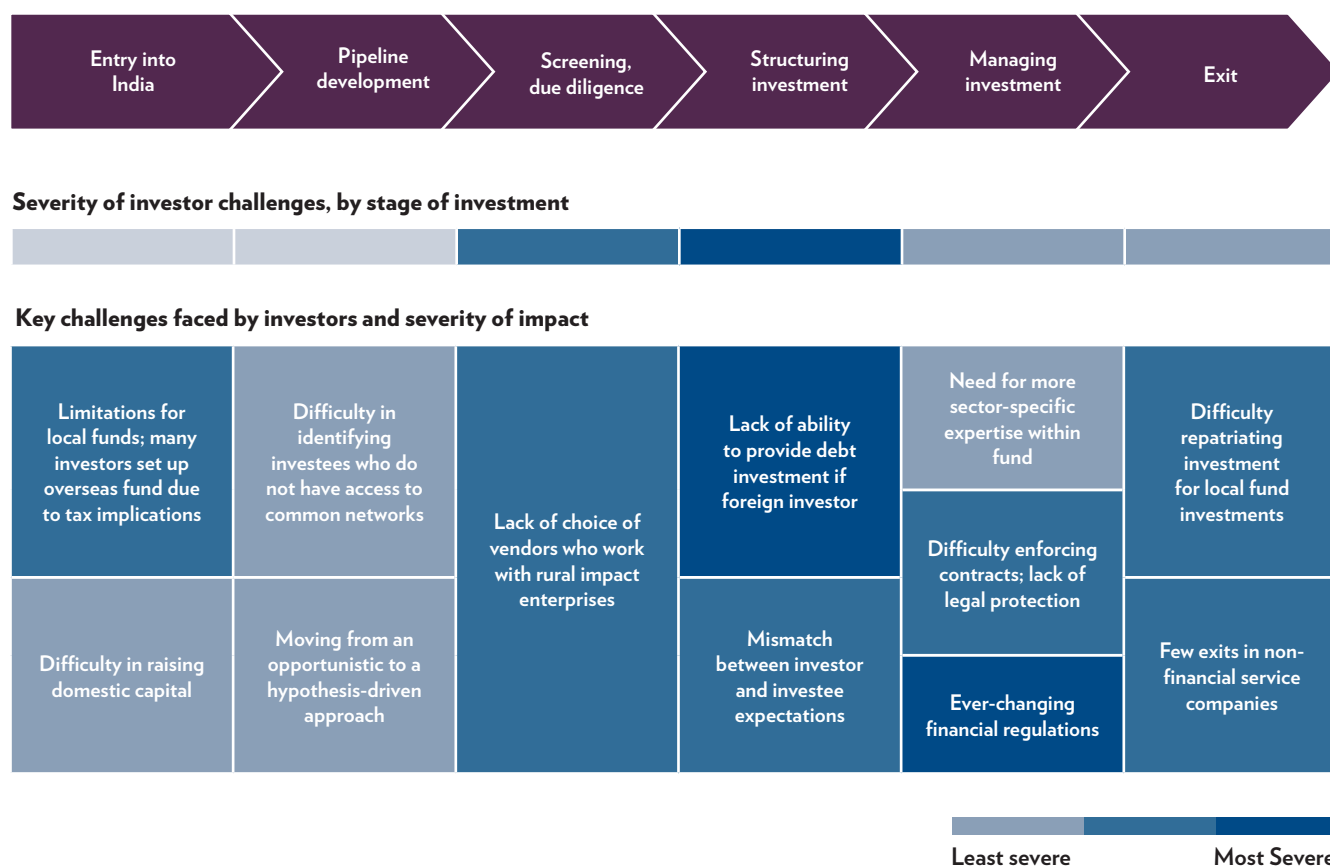
Challenges facing impact investors in India

Overall, India presents a relatively favorable market for the entry and sustainability of impact investors, given its consistent economic growth, rich entrepreneurial culture, robust impact enterprise ecosystem, and demonstration of successful exits. Investors generally believe that, while certain challenges do exist, none are prohibitive to initiating an India-focused fund or making an impact investment in India. Nevertheless, these challenges are outlined below.

Regarding entry into India, most challenges surround establishing an India-based fund. Funds based in India are subject to unfavorable and inefficient tax implications; as a result, due to tax treaties between India and other countries (for example, Mauritius or Singapore), fund managers often opt to establish these funds in foreign countries. Furthermore, in order to be an India-based fund, regulations require a minimum percentage of funds to be raised domestically (this percentage varies based on size of the overall portfolio). Raising domestic capital has historically been difficult, particularly when compared with raising foreign capital. While most fund managers find it an appropriate and manageable set-up to be based off-shore, a key drawback includes the lack of ability to provide debt financing as a foreign fund, which will be discussed further in this section.

Given a robust impact enterprise landscape, pipeline development in India is, on the whole, not seen as a major hurdle for investment; in fact, investors are becoming more proactive and strategic about their investments. Investors do not see a challenge in finding a sufficient number of investible enterprises in India. However, they do believe that there are a significant number of enterprises who do not have access to common investee/investor networks and therefore, do not receive equal chance of accessing funding as those that do. This differential access is likely to be driven by a variety of factors including language skills (those less comfortable with English are more disadvantaged) and location (rural entrepreneurs probably have less exposure to networks). As a result, investors are planning and willing to be more proactive in their search for investee organizations—not only moving towards a hypothesis-driven approach, as discussed above, but also committing a significant amount of resources to identify relevant organizations through field visits and active engagement on the ground.

FIGURE 15: CHALLENGES FACED BY INVESTORS IN INDIA



Source: Stakeholder interviews; Dalberg analysis

The primary concern at the screening or due diligence stage of an investment is the lack of affordable and experienced vendors. While several large consulting companies offer due-diligence services, investors find that these organizations do not always have sufficient experience working with impact enterprises, particularly those operating in rural areas.

Structuring and managing an investment pose the greatest challenges to impact investors in India. At the deal structuring stage, the lack of ability for foreign investors to provide debt capital inhibits their engagement with investees, particularly early- or growth-stage organizations, who are seeking debt financing. Furthermore, potential mismatches between investor and investee preferences, particularly in terms of the investee diluting its ownership and relinquishing substantial control to the investor who takes a seat on the board of directors, often arises as a result of a lack of intermediary support. Support from chartered accountants and due diligence consultants has gone far in bridging the gap, and is likely to go even further as more players enter the market.

While managing the investment, several additional challenges arise. First, given that many investors do not have sector-specific expertise within their teams, they are unable to provide sector-specific technical assistance to their investees. Second, due

to the inefficiency of the Indian legal system, investors cite difficulty in enforcing contracts. Lastly, tax laws affecting impact investors in India change often, with varying implications for investments.

Finally, while several exits in India have increased investor confidence, exits are not entirely without challenge. First of all, there have been few exits in sectors other than financial services, suggesting that sustainable models for exits in these sectors are yet to be seen. A significant amount of impact capital is tied up with these enterprises even beyond the planned exit timeline. Further, related to other issues for domestic funds that receive an initial capital investment from foreign investors, the repatriation process for capital upon exit is often difficult. Applications for repatriation need to be made to the Reserve Bank of India following an approval for disinvestment, and a “no objection” tax clearance certificate must be obtained from the Indian Income Tax Authorities.

Beyond the impact investing market

While beyond the scope of this particular study on India—especially given the deliberate focus on impact investors in this market—it is important to acknowledge a considerable amount of activity peripheral to the impact investing space. As in other countries, the presence of other institutional investors, banks, private equity (PE) and venture capital (VC) funds, angel investors, pension funds, and other conventional investors is strong in India. These conventional investors often invest alone or alongside other impact investors into impact enterprises as well as other enterprises (without impact intention) in sectors with potential for positive social or environmental impact. More so than in other countries under study, in India, we see a potential blurring of the lines between impact investing and conventional investing, as an increasing number of impact enterprises are seen as financially viable investments, where financial profitability inherently drives impact.

Looking forward

While a quantification of future committed funds is not within the scope of this study, all evidence points toward an impact investing market that will continue to grow and be robust in the future. Several existing fund managers are currently raising new funds for investments in India, and DFIs have already announced plans to commit additional impact capital for future deployment in the range of hundreds of millions of dollars, through both indirect investment into funds and direct investments into enterprises.

NEEDS AND OPPORTUNITIES: THE DEMAND SIDE

Overview of impact enterprise ecosystem in India

The impact enterprise landscape in India has been described by various studies, including Intellectap's 2012 Social Enterprise Landscape Report, GIZ's 2012 Market Landscape of the Indian Social Enterprise Ecosystem, and ADB's 2012 India Social Enterprise Landscape Report. Given the extensive literature already discussing the demand for impact capital in India, our aim is not to provide a comprehensive overview of the impact enterprise landscape, but to acknowledge the critical role that these enterprises play in driving trends and opportunities in impact investing in India.

The rapid growth of impact enterprises in India began in approximately 2005, with a particularly high growth in the number, scale, and prominence of for-profit impact enterprises having occurred since 2010. Correspondingly, the last decade saw a similar growth trajectory of the amount of impact capital within the country.

Most impact enterprises in India are in their growth stage, but the sector is relatively mature in comparison with its South Asian counterparts. Although examples of mature impact enterprises are limited, growth-stage companies have begun to achieve scale. In order to keep up with the growing sector and create a more formal establishment of impact enterprises in India, leading organizations came together in 2012 to create the National Association for Social Entrepreneurs (NASE) as a platform for advocacy.

A majority of impact enterprises today operate in the following four sectors: financial services, renewable energy, agri-business and livelihoods. The single largest sector within which impact enterprises operate (approximately 21%) is the financial services sector.¹⁵¹ The demand for capital within the financial services sector is largely what has driven the flows of capital into the sector over the past decade, as outlined in the section above. The financial services sector has received a significant policy push from the RBI and the government, and should continue to grow rapidly. Aadhaar, the unique individual identification scheme of the government, and the RBI's bank-led initiative for "a bank account for every Indian" might unlock potential for enterprises in this sector. Further, the adoption of technology-based services by the BoP, such as mobile payments, might also improve sector prospects. This is reflected in the optimism shown by impact investors towards this sector.

The renewable energy, agri-business, and livelihoods sectors each account for 15% of the total number of impact enterprises in India. Solar energy has been backed strongly by policy at the state and central levels in India, with the availability of attractive financing mechanisms. This has led to a growth in decentralized renewable energy and consumer product companies providing solar energy solutions. In the agri-

¹⁵¹ "Invest. Catalyze. Mainstream: The Indian Impact Investing Story," Intellectap, 2014.

business space, impact enterprises have tried to plug the severe inefficiencies in the agricultural supply chain in India, with a focus on empowering the smallholder farmer. Livelihoods companies such as rural business process outsourcing centers have tried to equip rural individuals with jobs and disincentivize migration to urban areas.

Healthcare, education, and technology-based services are trending sectors for the growth of impact enterprises in the future. In addition to other sectors in which impact enterprises operate, such as affordable housing and water and sanitation, the affordable healthcare space has seen a few impact enterprises achieve scale and maintain financial viability. Education represents a large opportunity; however, the sector is still being explored beyond vocational training. Challenges in the sector include difficulties caused by changing government regulations and poor infrastructure. Lastly, with the high level of mobile connectivity in India, enterprises that can deliver services via mobile devices are likely to have a huge opportunity to scale. This is likely to attract a large number of enterprises to this space.

Many impact enterprises now adopt the philosophy of impact as inextricably linked to profitability in their business models. Certain enterprises reject the label of a “social enterprise” or “impact enterprise” because of the association of these terms with the idea of not seeking profits. Some enterprises believe that the label reduces the attractiveness of a company seeking equity or debt from conventional financial institutions. As such, the boundaries between traditionally labeled impact/social enterprises and mainstream enterprises may become increasingly blurred.

Access to finance

Impact enterprises seek different financing instruments at various stages of their lifecycle. Grants and working capital loans are prioritized at an early stage, equity at early and growth stages and long-term debt at growth and mature stages. Due to availability of capital, however, enterprises are often forced to engage in investments that may not be optimal for their business, such as taking on equity at an earlier stage than is preferable because they cannot access debt.

Depending on their stage of lifecycle, entrepreneurs face varying difficulties in accessing finance. In particular, seed-stage enterprises find it very difficult to secure finance, particularly in the form of working capital debt. As the impact investing sector matures, with a greater number of profitable exits and increasing investor confidence over time, the perceived riskiness of these seed-stage impact enterprises is likely to fall. Even for growth-stage enterprises that have received equity infusions, access to long-term debt is challenging. This is primarily due to the lack of lender-accepted collateral, and the inability of these enterprises to meet the three years of profitability criterion of banks. Furthermore, in sectors that banks do not understand very well, such as renewable energy and sanitation, this issue is exacerbated.

Given the difficulty of working in rural areas and with BoP customers and producers, impact enterprises aim to grow revenue and profitability over a longer period of time than do conventional enterprises. Impact enterprises catering to BoP customers often have difficulty in payment collection. This is largely because their customers are unable to pay regularly and reside in hard-to-access rural areas.

As a result, these enterprises require a significant amount of time to achieve scale and ensure stable revenue flows. “Patient capital,” often provided by impact investors, is the best fit to address this need.

Although a fair number of impact enterprises have remained financially viable, fewer have achieved profitability. An Intellectap survey¹⁵² found that half of the enterprises surveyed had annual revenues of over INR 50,00,000 (approximately USD 83,000), in the financial year 2010-2011. A quarter of all enterprises in this sample reported being profitable over the same period. However, this is in part attributed to the fact that a majority of surveyed enterprises had been in operation for less than three years.

Limited financial knowledge as well as a lack of adequate support in structuring financial deals are key constraints for impact entrepreneurs in India. Financial experts, such as chartered accountants and investment bankers, are beginning to support impact enterprises in the process of seeking capital, and structuring deals in a way that is most beneficial and least harmful to the enterprise. However, with few intermediaries such as these engaging in the process to date, impact enterprises often negotiate on their own and thus, lack the financial expertise that comes with having advisory support. In addition, with the lack of access to debt financing at an early stage in their lifecycle, impact enterprises often receive equity early on, which significantly dilutes their ownership and results in lower valuations than they might have achieved at a later stage. Impact enterprises openly advise that giving up controlling shares may lead to disagreements between the investor and the investee, and as a result, a loss of motivation and potentially a faltering business. Therefore, an opportunity exists for additional intermediary support organizations to bridge the gap between investors and enterprises.

The investor-investee relationship, beyond the point of deal structuring, experiences further tension at later stages during the relationship. Enterprises sometimes feel as though investors have expectations of returns that are difficult to meet, and that they play too heavy a role on the company board. However, while there is room for improvement, most impact enterprises, particularly those at early and venture stages of growth, prefer receiving investments from impact investors over conventional investors given mission alignment.

152 “On the path to sustainability and scale,” Intellectap, 2012.

Constraints to enterprise growth

Acquiring operational and managerial skills, as well as recruiting and retaining quality talent, are key constraints acknowledged by impact enterprises in achieving scale and profitability. In several cases, entrepreneurs have deep content expertise and passion for their work, but may not have the business skills or experience required for financial success. Incubators and even investors who provide support and hand-holding often play a significant role in supporting organizational scale-up. A skill deficit in the talent pool, as well as a potential lack of focus on human resource development within impact enterprises, is another challenge to achieving growth and scale.

The policy environment under which impact enterprises operate offers financial and technical support, but awareness about how to access this support is low. The Small Industries Development Bank of India (SIDBI)¹⁵³ and the National Bank for Agriculture and Rural Development (NABARD)¹⁵⁴ are two domestic development banks that offer a variety of financial schemes for micro and small enterprises. However, knowledge of these schemes is low among many impact enterprises. Enterprises that are aware of these schemes are unsure of how to access them, or find that bureaucratic processes in their implementation restrict access.

Lastly, while India does provide a nurturing environment for impact entrepreneurs, the enabling factors for success are not necessarily accessible to everyone. India enjoys a far-reaching entrepreneurial spirit, opportunity for innovation across sectors, and several networks and forums for technical and managerial support. However, many entrepreneurs remain unreached, particularly those residing and working only in rural areas, those who have poor English language skills, those who do not have access to networks of well-connected individuals and organizations, and those who have simply not sought involvement from incubators or investors. To date, enterprises that are identified, funded, and showcased are often those who already are well connected or who specifically seek out funding. As a result, there exists significant untapped potential in identifying innovation through more proactive and different channels, given an investor's appetite to do so.

¹⁵³ SIDBI is a public sector financial institution set up to aid the development of MSMEs

¹⁵⁴ NABARD is the apex development bank in India. Its main focus is to uplift rural India by increasing the credit flow to the agriculture and rural non-farm sector. It is also active in developing a financial inclusion policy.

ENABLING IMPACT INVESTING: THE ECOSYSTEM

Support services for impact investors and enterprises have evolved greatly with the entry of new types of players and the formation of platforms. Intermediaries and incubators focusing on impact enterprises have entered the market and have been growing in number and in scale. These intermediaries include (i) investment bankers, such as Unitus Capital, who help broker deals between funds and enterprises; (ii) specialized chartered accountancy (CA) companies that are in high demand in the market; and (iii) incubators such as Unltd India, Dasra and the Centre for Innovation, Incubation and Entrepreneurship that provide support to enterprises early on in their lifecycle. The intermediaries' expertise lies in analyzing enterprise data and business models, conducting field visits to verify their information and completing the due diligence process. Incubators are instrumental in providing advisory services, such as developing a business pitch, and in connecting impact enterprises to the right networks. However, some experts believe that incubators should shift their focus to provide operational, management, and mentorship support to impact enterprises, in order to make the most impact.

Portraying the maturity of the space, various platforms have been set up to connect impact investors, enterprises, DFIs and other relevant financial institutions. These platforms bring stakeholders to the table to share information and to plan advocacy efforts. For example, the formation of IIC and NASE has shown how investors and enterprises are organizing themselves to meet common goals. This is discussed in detail below. In addition, the Sankalp Forum has facilitated a common platform for stakeholders, from investees to investors to ecosystem players, within the impact investing landscape to interact with one another.

Figure 16 provides an overview of players who support the overall impact investing landscape in India.

FIGURE 16: ECOSYSTEM STAKEHOLDERS IN INDIA

Incubators/Accelerators



TA Providers



Credit Rating Services



Intermediary Support Providers



Source: Dalberg analysis

Domestic development banks SIDBI and NABARD also play a role in boosting SME financing activity. However, awareness of their programs remains low among some impact enterprises, while others believe that they are hard to access. Among SIDBI’s various activities, the Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) scheme and its subsidiary venture capital arm, hold significant potential to scale up finance to impact enterprises. SIDBI’s CGTMSE scheme provides credit guarantee support to collateral-free and third-party guarantee free loans. This enables SMEs, who usually struggle to have adequate collateral, to access unsecured loans of up to INR 10,000,000 (approximately USD 167,000). However, financial institutions are often apprehensive to provide loans under the CGTMSE scheme. This is largely due to the lengthy process involved in claiming their loan amount in the case of a default. In these cases, bank branch managers have no incentive to take accountability for defaults on loans their branch disbursed. Another shortfall is that many impact enterprises are unaware of the scheme. Of the few that are aware, most do not know how to access it, or perceive the process to be too lengthy. An improvement in these mechanisms would enable a scale-up of enterprise debt financing.

SIDBI VC, a key SME financing player, was set up in 1999 to provide capital and strategic advice for micro, small, and medium enterprises (MSMEs). Under SIDBI VC, a number of funds have been created to provide support to various sectors. Most notably for impact enterprises, the Samridhi Fund, created in association with DFID, aims to provide finance to sectors in which impact enterprises typically operate. The life of the fund is due to extend to June 2020.

As the apex development bank in India, NABARD has the opportunity to play a significant role in improving access to finance for impact enterprises, for example in the provision of soft loans. However, most impact funds and enterprises perceive NABARD to be a bureaucratic government organization from which it is difficult to obtain financing. Some impact enterprises are not even aware that they can get support from NABARD. Similarly, funds believe that NABARD's sector involvement has been too limited.

The current regulatory environment, while not prohibitive to conducting business in India, does pose several constraints. First, investors find it difficult to operate with tax laws that change often, and with little to no prior notice. This affects investor profitability and financial activity. Adding to their concerns, under the General Anti-Avoidance Rules (GAAR) of the Indian Government, investors can be taxed retroactively. Considering these factors, impact funds operate in an uncertain environment. Moreover, the RBI regulations do not cover the deployment of certain instruments, such as non-convertible preference shares, and foreign investors are limited in providing debt to Indian enterprises. In addition, market players express concerns over policies and regulatory requirements that differ across states in India, which force funds and businesses to incur seemingly unnecessary costs of compliance.

In terms of implementation, bureaucratic processes and red tape create significant costs and delays in opening and operating a business. According to the World Bank Doing Business Rankings 2014, India ranks 158th in the world in ease of starting a business, suggesting a potentially discouraging environment for new entrepreneurs. Subsidies and government schemes can also sometimes be deterrents to investing in and operating impact enterprises primarily due to delays in disbursement and bureaucracy in the selection processes for enterprises. Many funds are unwilling to invest in subsidy-dependent businesses for this reason. In the case of funds, challenges around enforceability of contracts and resolving insolvency if a portfolio company was to fail are a cause for concern. Many impact funds are concerned about the slow judicial process when resolving such disputes. As a reflection of these issues, India ranks 186th and 137th in enforcing contracts and resolving insolvency in the Doing Business Rankings for 2014. This makes funds particularly cautious when deciding whether to invest in a particular enterprise, as they perceive a higher risk on investments, reducing the number of deals they close.

While posing some constraints to the growth of the impact investing industry, the regulatory environment in India also offers several opportunities for impact investors. The SEBI has taken several measures to improve the regulatory framework for funds, and the financing avenues for SMEs. SEBI, as the capital market regulator, has been the focal point for improving investment conditions and the modernization of the Indian financial system. In 2012, SEBI approved the creation of Alternative Investment Funds (AIFs) in India for the purpose of pooling capital from Indian and

foreign investors for investing as per a pre-decided policy. “Social venture funds” (SVF) fall under the first of three categories of AIFs, entitling them to certain incentives from the government, SEBI, or other regulators as they are perceived as making a positive impact beyond financial returns.¹⁵⁵ This provides a pathway for the creation of more domestic funds. For example, the domestic Incube Connect Fund is registered as an SVF.

Further, in 2013, SEBI amended the policy to mandate the creation of angel funds, paving the way for a formal framework under which angels can operate as an investor group. SEBI is also leading the establishment of an SME stock exchange with the primary aim of funneling more equity investment to SMEs. However, experts believe that awareness about SEBI’s schemes remains low among impact entrepreneurs and needs to be improved for impact enterprises to benefit from them.

Another incentive for foreign impact funds to operate in India is the tax treaty between India and Mauritius, which allows foreign direct investors to avoid certain taxes. As a result, a few leading impact investors with an India focus have their funds registered in Mauritius. This, however, prohibits the funds from engaging in debt transactions in India, as discussed above.

In order to further advocate for a supportive regulatory environment, set industry standards and achieve common goals, impact funds and enterprises have organized themselves into separate organizations—IIC and NASE—as discussed above. In 2013, leading impact investors conceptualized the IIC, a non-profit organization that aims to serve as a self-regulatory initiative and provide more information, standards and transparency for impact investing in the Indian context. This council comprises approximately 25 members of the industry including Omidyar Network, Caspian, Acumen Fund, and Elevar Equity. The expectations from this industry body will be (i) to collaborate to provide a unified view of the space and the impact being made, (ii) to address policy issues to provide a conducive market for investors to get consolidated information, and (iii) to set up a platform for dialogue. Currently, many impact funds see the IIC as a very effective localized body for policy advocacy and for sharing information. However, they note that the IIC is still in its early phases and has yet to establish a formal working body. Experts believe that the IIC’s success will hinge on building consensus among investors, which they believe could prove difficult.

Established in 2012 by successful social entrepreneurs across sectors, NASE has pioneered the creation of a platform that represents entrepreneurial interest. It was founded by Indian enterprises including Vaatsalya, RuralShores, EnglishHelper, and Husk Power Systems, with the goal of advocating, lobbying, and partnering with key stakeholders to improve the ecosystem for impact enterprises. NASE is also focusing on setting standards for impact enterprises in India and helping entrepreneurs scale rapidly. Identified by experts and market players as a key need, NASE aims to bring entrepreneurs together, share their learnings and help each other grow. These entities believe that if NASE can develop bargaining power for advocacy, it can improve the industry to a great extent.

¹⁵⁵ Other types of funds that fall under AIF are SME funds, VC funds, and infrastructure funds.

Overall, a rich entrepreneurial ecosystem makes India an attractive destination for impact capital, with a relatively mature enabling environment and bright prospects for the future. Compared with emerging economies, India's impact investing industry is robust and growing. Since 2004, India has witnessed rapid growth in the inflow of impact capital and the number of funds with Indian investees. DFIs invest billions of dollars each year, and approximately 20 out of the 50 impact funds included in the study have allocated the majority of their portfolio (or, in some cases, their entire portfolio) to investing in Indian enterprises. These fund managers remain bullish on future prospects, while many plan to set up new India-specific funds in the near future. Co-investments from conventional investors demonstrate the feasibility of earning market rate returns on impact investment and suggests a potential mainstreaming of the sector in the next decade. Leading impact enterprises have achieved scale, and in the recent years, there have been at least 17 profitable exits from impact investments. These developments, along with a supportive macroeconomic environment, have built India's reputation as a vibrant destination for impact capital.

ANNEXES

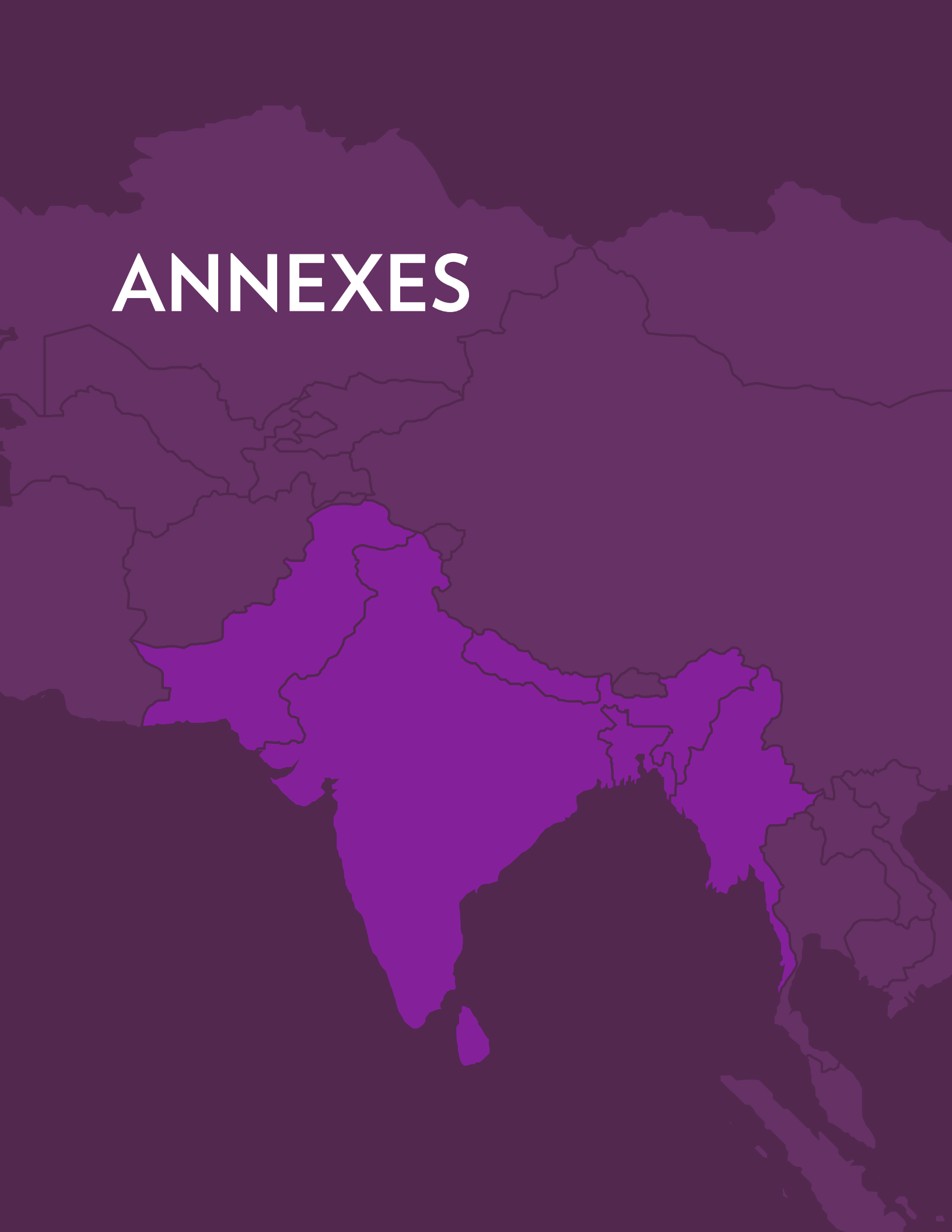


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BANGLADESH

Annex 1—Interview participants

FUND MANAGERS

- Subrata Mitra and Dipok Kumar Roy, *Venture Investment Partners Bangladesh Ltd*
- Marten van Middelkoop, *Incluvest*
- Md. Minhaz Zia, *Asian Tiger Capital Partners*
- Shawkat Hossain and Muhammad Raisul Amin, *BD Ventures Limited*
- Maksudul Islam, *Brummer & Partners*
- Jerry Nicholson, *Tindercapital*
- Mohammad Altaf and Uz Zaman, *SEAF Bangladesh Ventures*
- James Perry, *Panahpur*

DFIS

- Arsalan Alfred M. Ni and Sayef Tanzeem Qayyum, *International Finance Corporation*

INSTITUTIONAL INVESTORS

- Ershad Hossain, *The City Bank Ltd.*
- Mominul Islam, *IPDC*
- Habib Yousuf, *Habib Bank*

ECOSYSTEM PLAYERS

- Farooq Sobhan, *Bangladesh Enterprise Institute*
- Samira Zuberi Himika, *Team Engine*
- Saifur Rahman, *LightCastle Partners*
- Jerry Nicholson, *Open Accelerator*
- Maroof Mohsin, *Yunus Centre*
- Mustafizur Rahman Khan, Samad Miraly, and M Fayaz Taher, *The Wave*
- Mahmudul Hasan Sohag, *Onnorokom Group*
- Muzaffar Ahmed, *CRISL*
- Serajul Islam, *EEF*
- Arif Khan, *SEC*

- Md. Masum Patwary, *Bangladesh Bank*
- AK Chowdhury, *Hoda Vasi Chowdhury & Co*

IMPACT ENTERPRISES

- David How, *Oasis Coffins*
- Samantha Morshed, *Pebble Child*
- Minhaz Anwar, *Better Stories*
- Amer Khan, *Magnito Digital*

Annex 2—Survey respondents

FUND MANAGERS

- Subrata Mitra, *Venture Investment Partners Bangladesh Ltd.*
- Marten van Middelkoop, *Incluvest*

INSTITUTIONAL INVESTORS

- Ershad Hossain, *The City Bank Ltd.*
- Mominul Islam, *IPDC*

ENTERPRISES

- Amer Khan, *Magnito Digital*
- Asif Saleh, *BRAC Bank Ltd.*

NEPAL

Annex 1—Interview participants

FUND MANAGERS

- Bidhya Sigdel and Shabda Gyawali, *Dolma Development Fund*
- Willem Grimminck and Niraj Khanal, *One to Watch*
- Saurya SJB Rana, *Tara Management Pvt. Ltd*

DEVELOPMENT FINANCE INSTITUTION (DFI)/ INTERNATIONAL FINANCIAL INSTITUTION (IFI)

- Navin Dahal, *DFID*
- Deep Karki, Valentino Bagatsing, and Santosh Pokare, *IFC*

ECOSYSTEM PLAYER

- Vidhan Rana and Sanam Chitrakar, *Biruwa Ventures*
- Suman Rayamajhi, *Eos Advisors*
- Prabhat Shrestha and Robin Sitoula, *Lead International*
- Radesh Pant, *Nepal Investment Board*
- Willem Grimminck, *Rock Start*
- Saurabh Rijal, *Saadhya*
- Niraj Giri and Mukti N. Shrestha, *Securities Board of Nepal*

ENTERPRISES

- Kumud Sing , *Alpine Coffee Estate*
- Bhuwan K.C., *Ecoprise*
- Samir Newa, *The Organic Village*
- Anand Bagaria, *Pro Bio-Tech Industries and Nimbus International Co.*

Annex 2—Survey respondents

FUND OR FUND MANAGER

- Willem Grimminck and Niraj Khanal, *One to Watch*

ECOSYSTEM PLAYER

- *Solutions Consultant Pvt. Ltd.*

ENTERPRISES

- Kumud Sing, *Alpine Coffee Estate*
- Bhuwan K.C., *Ecoprise*
- *Health at Home Pvt. Ltd.*
- Anand Bagaria, *Pro Biotec/NIMBUS*
- *Shree Krishna Livestock Devt. Farm*
- *WindPower Nepal*

PAKISTAN

Annex 1—Interview participants

FUND OR FUND MANAGERS

- Ahmad Jalal, *Abraaj Group*
- Saima Irtiza, *Acumen Fund*
- Ali J. Siddiqui, *JS Group Private Equity Fund*
- Valerian Fauvel, *Insitor*
- Ali Saigol, *IndusBasin*

DFIS/IFIS

- Waqas Hassan, *DFID*
- Faeyza Khan, *IFC*
- Fay Chetnakarnkul, *Norfund*
- Yasir Ashfaq, *Pakistan Poverty Alleviation Fund*
- Maryam Riaz, *USAID*

INSTITUTIONAL INVESTORS

- Shoaib Ahmad, *State Bank of Pakistan*
- Rashid Bajwa, *National Rural Support Program*
- Atyab Tahir, *Tameer Bank*

ECOSYSTEM PLAYERS

- Fiza Farhan, *Buksh Foundation*
- Jeremy Higgs, *Ecoenergy Finance*
- Roshaneh Zafar, *Kashf Foundation*
- Asher Hasan, *Neya Jeevan*
- Kasloom Lakhani, *Invest2Innovate*

Annex 2—Survey respondents

FUND OR FUND MANAGERS

- Saima Irtiza, *Acumen Fund*

SRI LANKA

Annex 1—Interview participants

FUND OR FUND MANAGERS

- Niroshan Kurera, *Etimos Lanka Pvt. Ltd.*
- Indika Hettiarachchi, *Jupiter Capital Partners*
- Chandrien De Mel, *Lanka Ventures PLC*
- Chanaka Wickramasuriya, *LR Global*

DFIS/IFIS

- Kamal Dorabawila and Dinesh Warusavitharana, *IFC*

INSTITUTIONAL INVESTORS

- Senaka Kakiriwaragodage, *National Development Bank PLC*

ECOSYSTEM PLAYERS

- Steve Francone, *Good Market*
- SA Deepthi Kumari, *National Enterprise Development Authority*
- Hastitha Assiriyage, *SME.lk*

ENTERPRISE

- Anura Atapattu, *Berendina Microfinance*
- Ausha Alles, *Bradix*
- Saman Kathurithathne, *Herbal Health Ceylon*
- Charith Jagoda, *LOLC Micro Credit Limited*
- Charitha Ratwatte Jr., *Rural Returns*
- Selyna Peiris, *Selyn Handlooms*
- Amanda Kiessel, *Sevalanka Foundation*
- Ara Pararajasingham, *Sunshine Holdings*

Annex 2—Survey respondents

FUND OR FUND MANAGERS

- Niroshan Kurera, *Etimos Lanka Pvt. Ltd*
- Augustin Vitorica, *GAWA Capital*

ENTERPRISE

- *Shri Jayawardanapura*
- *The Bread Company*
- *WOOD 4 KIZ*
- *Flow Health Bar*

MYANMAR

Annex 1—Interview Participants

FUND OR FUND MANAGERS

- 1 Anonymous Private Equity Investor
- Bradley Kopsick, *Insitor Capital*
- Catherine A. Smith, *Anthem Asia*
- Oliver Belfitt-Bash, *RONOC*

DFIS/IFIS

- Thatha Hla, *ADB*
- Thomas Foerch, *GIZ*
- Vikram Kumar, *IFC*
- Daniel Kostzer, *UNDP*

ECOSYSTEM PLAYERS

- Mi Mi Myo Win and Tristan Ace, *British Council*
- Emmanuel Maillard, *Building Markets*
- Thuta Aung, *Hamsa Hub*

ENTERPRISES

- Hannes Manndorff, *Accion*
- Cathy Win, *Good Sleep*
- Cathy Win, *Good Night*,
- Cathy Win, *Good Job*
- Allen Himes, *Indigo Energy*
- Zin Mar O and Sam Kang, *Kant Kaw Education Center*
- Steve Dowall, *Livelihoods and Food Security Trust Fund*
- Richard Harrison, *PACT Myanmar*
- M.T. Winn, *Shwe Minn Tha*
- Myo Win, *Smile Education and Development Foundation*
- Wunna Aung, *Sprinkles*
- Cavelle Dove, *Yangon Bakehouse*

Annex 2—Survey Respondents

ECOSYSTEM PLAYERS

- Thuta Aung, *Hamsa Hub*

ENTERPRISES

- Thuta Aung, *Hamsa Hub*
- Cavelle Dove, *Yangon Bakehouse*

INDIA

Annex 1—Interview participants

FUND MANAGERS

- Vikas Raj, *Accion Venture Lab*
- Payal Shah and Suzanna Thekkeker, *Acumen Fund*
- Rema Subramanian, *Ankur Capital*
- Mona Kachhwaha, *Caspian Impact Investment Advisors*
- Sandeep Farias, *Elevar Equity*
- Venky Natrajan, *Lok Capital*
- Anand Chandnani, *responsAbility*
- Karthik Chandrasekar, *Sangam Ventures*
- Eleanor Horowitz, *Unitus Seed Fund*
- 1 Anonymous Private Equity Investor
- 1 Anonymous Venture Capital Firm

DFIS

- Tracey Austin, *CDC*
- Kunal Makkar, *DEG*
- Tony Bakels, *FMO*
- Jan Stilke and Florian Arneth, *KfW*

FOUNDATIONS

- Abhijit Nath, *Michael Susan and Dell Foundation (MSDF)*
- Govind Shivkumar, *LGTVP*
- Badri Pillapakkam, *Omidyar Network*

ECOSYSTEM ACTORS

- Megha Jain, *Dasra*
- Pooja Warriar and Tej Dhami, *UnLtd*
- Anuj Sharma, *ASCo*
- Usha Ganesh, *Intellecap*
- Amit Kumar Rathi, *Unitus Capital*

ENTERPRISES

- Sonali Mehta-Rao, *Mela Artisans*
- Rajeev Kher, *Saraplast*
- 1 Anonymous Education Enterprise
- 1 Anonymous Financial Inclusion Enterprise



ABOUT THE GLOBAL IMPACT INVESTING NETWORK

The Global Impact Investing Network (GIIN®) is a nonprofit organization dedicated to increasing the scale and effectiveness of impact investing. The GIIN builds critical infrastructure and supports activities, education, and research that help accelerate the development of a coherent impact investing industry. For more information, see www.thegiin.org.

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