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Scaling Inclusive Business Investments

Nicolas Chevrollier - BoP Innovation Center
Irmgard Jansen - BoP Innovation Center
Niek van Dijk - BoP Innovation Center
Myrtille Danse - BoP Innovation Center

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The opportunity: Investing in Base of the Pyramid markets

More than four and a half billion people earn less than eight dollars a day. In spite of the enormity of this market, it is one that is often overlooked by business.

This market segment is referred to as the Base of the Pyramid, and includes value demanding consumers, resilient and creative entrepreneurs, producers, business partners and innovators. Engaging these groups in sustainable and profitable business is key to improving their livelihood and economic growth. Inclusive business contributes to poverty reduction through the inclusion of low income communities in business processes, both as producers and consumers.

The size of the overall potential market for essential goods and services for the Base of the Pyramid (BoP) markets housing, rural water delivery, maternal health, primary education and financial services is estimated at \$ 400 billion to \$1 trillion over the next ten years (IFC, 2010). This market provides great opportunities for 'impact investors'. These are investors that aim for a combination of social, environmental and economic impact and are willing to accept higher risks and lower returns.



Impact investing

It is becoming clear that there is a ‘missing middle’ between micro finance and the regular financial instruments available to support companies developing products and services for BoP markets.

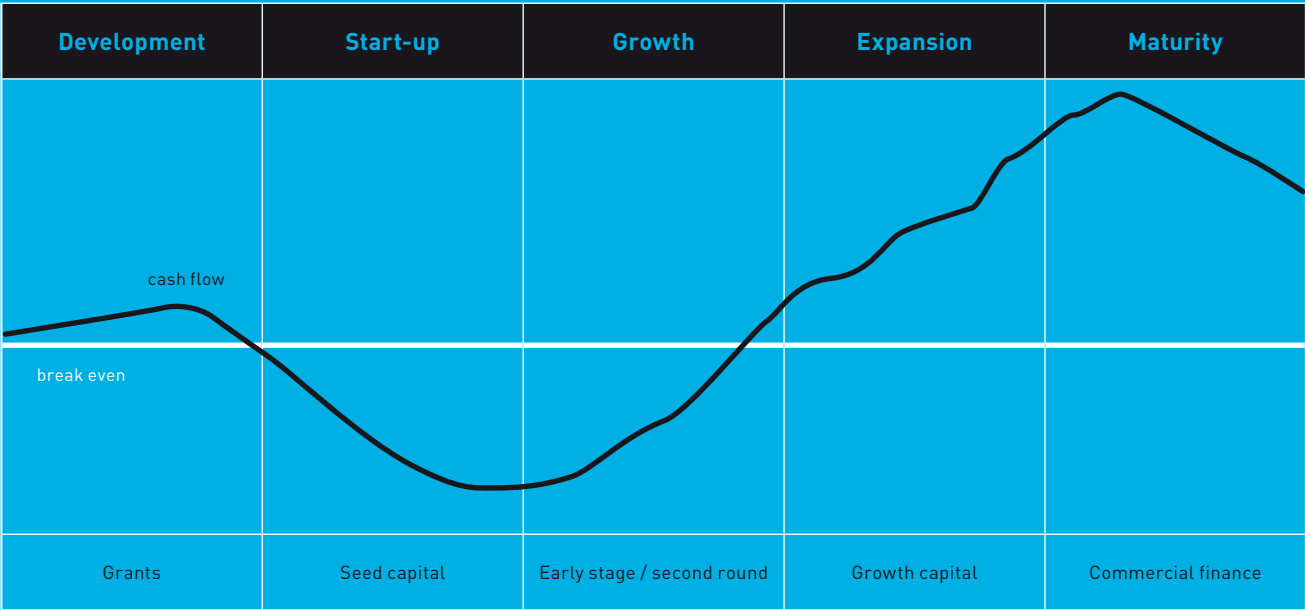
This missing middle is particularly predominant in financing BoP ventures in early stages of development or in the pioneer gap: i.e. the gap in time and money between the formation of the firm and the generation of a positive cash flow. Although this is particularly true for SMEs in the early stages, more mature SMEs face similar challenges. Due diligence costs, servicing costs, transaction costs and retraction costs are usually too high for the size of the investments needed. Impact investors play an increasingly important role for the ‘missing middle’.

The majority of impact investors are prepared to take larger risks and accept longer tenors, i.e. the amount of time left for the repayment of a loan or contract or the initial term length of a loan. Some of them demand lower financial returns on the condition that the investment will create jobs with good benefits and working conditions and that the investment will have a positive impact on society and / or the environment. In other words: the impact investor actively

looks at risk, return and social impact whereas commercial banks mainly take risk and return into consideration. In addition, most commercial investors would not consider any sort of financial investment less than €2 million because assessing the business, validating the assumptions and going through the due diligence process would take too much time and effort. Many impact investors consider applications around €500,000. For microfinanciers these sums are usually too large and for commercial banks too small. However, the funding requirements of local SMEs as well as local or international businesses developing innovative business cases, often settle between €50,000 and 300,000.

There are very few financial players that move into this investment space. There is a mismatch between capital supply and demand which increases the failure rate of inclusive business at an early stage of development and causes difficulties for investment funds to fill their pipelines.

figure The pioneer gap



Barriers to scaling impact investing in Inclusive Business

A number of barriers limit the potential of scaling up investments in Inclusive Business. These barriers result in a mismatch between capital demand and supply.

Mismatch between capital demand and supply

Identifying potential impact investment opportunities, conducting due diligences and completing a transaction all require considerable time and resources. Many investors shy away from small-scale opportunities in developing countries because the administrative costs are too high. And as long as the inclusive businesses do not receive sufficient assistance to improve their plans, the number of investment opportunities will remain low. The investment barriers result in a lack of funding opportunities. In other words: impact investors do not receive sufficient numbers of business proposals that meet their investment criteria. This results in a mismatch between capital demand and supply.

There is insufficient capital for the early stages of business development that carries high risks. For the majority of impact investors the risk profile is too high for both innovative business models and technology solutions for the BoP markets.

Inadequate duration of traditional funding: Traditional funding by banks through loans is often not available for BoP ventures, due to their lack of collateral and a traditionally tight schedule of repayments. In the case of traditional venture capital equity, the expected exit of shares will be on average 5 (3 - 7 years) years. In BoP markets it can be up to 10 years or more. Altogether there is a need for longer term equity and debt capital for BoP development.

Inadequate granularity of funding available: Besides the duration of financing itself, the amount of money requested in this early stage is smaller than average. Financial institutions and impact investors tend to move to amounts higher than US\$ 1 million and do not serve this particular area, due to an expected low return on investment.

Lack of combination between investment and technical assistance: Inclusive business proposals are often not investment ready. They would benefit from receiving technical assistance (e.g. business plan improvement, pitch improvement) in combination with investment. However, investment and technical assistance are often not combined. Structures to support inclusive business are emerging (e.g. Inclusive Business Accelerator) but their impact is still too limited.

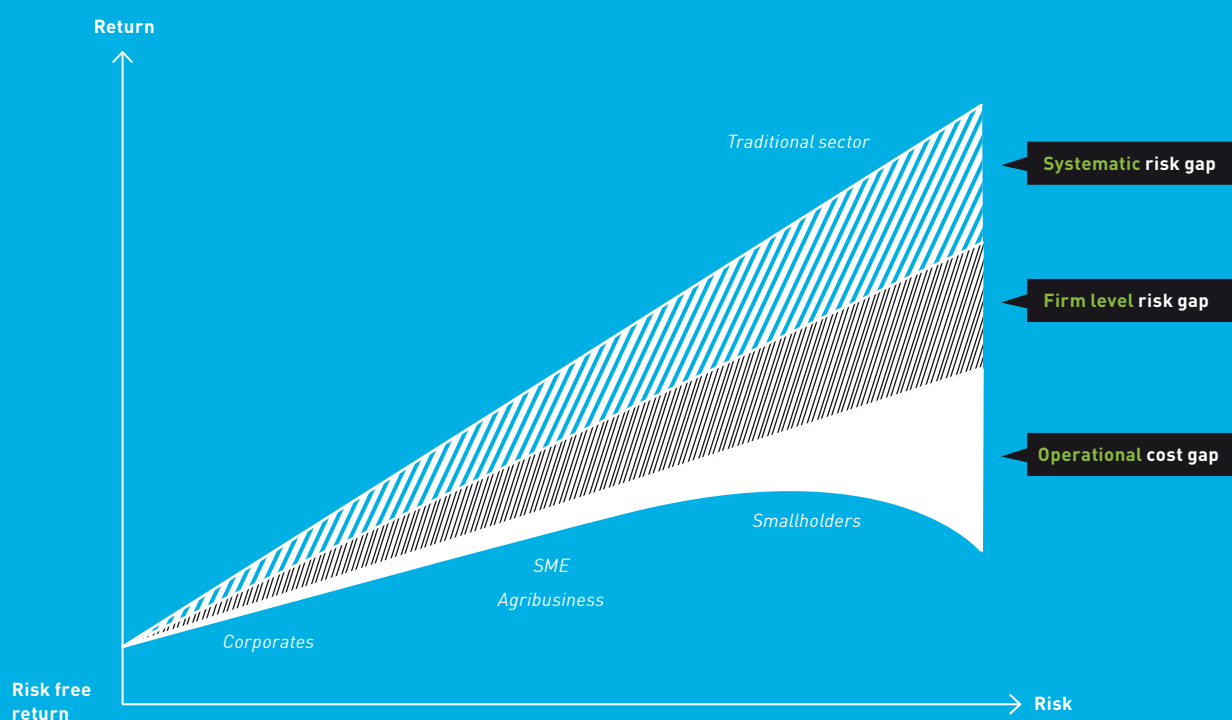
Systemic risk gap

Risks Barriers: Enterprises that form the 'missing middle' are generally perceived by banks and financial institutions as risky and potentially unprofitable. Furthermore, there is often a misalignment between the financial strategy of fund managers and investors. This is reflected in different or non-existing incentives and divergent expectations and motivations.

Institutional Barriers: Countries that appear as 'donor darlings' do not always provide a suitable investment environment for private capital. Furthermore, the costs of identifying and developing promising investment opportunities is prohibitive for most investors. The prominence of the informal sector in BoP markets can make the valuation of companies challenging.

The immature financial systems in expansion markets form yet another institutional barrier. There is lack of competition and commercial banks can often earn high returns from lending to large public and private entities. This makes it less necessary and less appealing to invest in smaller enterprises.

figure 1 Risk / return matrix for financial institutions



Systematic risks apply to every entity in a sector and are difficult to predict or prevent (weather, crop failures, etc.)

Firm-level risks apply to individual organizations and can be mitigated at reasonable costs (poor governance, poor production capacities, etc.)

High operational costs are caused by poor quality and availability of information, costly credit analysis processes, high monitoring costs, etc.

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Source: Scope Insight and IFC, 2014

Investors

"We have finance, but can't find good business plans. We need a pipeline."

Risk

IB often needs early stage investments which are more risky

Reward versus costs

Relatively low deal size compared to costs of due diligence etc.

Understanding of IB

New economic sector with different dynamics

IB Ventures

"We have good business plans, but can't get the finance."

Finance literacy

Poor financial literacy and limited business model development to set up a sound business plan

Oversight of finance opportunities

Limited time to orientate on vast landscape of finance opportunities

Mindset on finance

Moving from grants to 'real' investments



Approach on the demand side

Ecosystem of training providers

- A structural business graduation system for IB and IB advisors
- Aligned with market demands and based on common learning standards
- Based on a common language



Approach to bridge the gap

- Providing information (from assessments)
- Bringing together stakeholders, based on a common language



Approach on the supply side

Ecosystems of the market

- Build knowledge, capacity and tools
- Lower the hurdle to enter the sector
- Offer an attractive potential pipeline

Source: Scope Insight and IFC, 2014

Policy and Regulatory Barriers: A regulatory framework conducive to financing BoP ventures is often lacking. Public policy is sometimes a distorting factor e.g. limitation in interest rates in a given sector.

Skills, Knowledge, Information and Training Barriers: Inclusive business is a nascent private sector approach. Fund managers and financial institutions often lack indepth knowledge in this area. They miss the right expertise or instruments to service this segment. Moreover, some entrepreneurs lack the required skills for example in writing high-quality business plans and clearly defining the financial needs of their business. Furthermore, the entrepreneurs often do not have a track record, administrative records or sufficient collateral. Risk sharing or risk management facilities are also usually not present.

Deals need to be created and this requires a hands-on approach both from the side of investors and from the side of the entrepreneurs. To create scalable investment proposals and to generate a pipeline, the conditions in the investment ecosystem need to be improved. Information needs to be easily accessible. Relevant stakeholders need to be connected to each other and build a common understanding of the challenges and opportunities. Capacity building and technical assistance are required on both the demand and the supply side. Investors are reluctant and generally not prepared to pay for this.

Shared roadmap to overcome impact investment challenges

The challenges around impact investing are becoming quite clear. It is also clear that these problems cannot be solved by individuals or just one segment of the business ecosystem. The actors involved – impact investors, inclusive businesses, business consultants and governments – need a shared roadmap including financing mechanisms and adequate business support to reach larger impact in BoP markets.

Relevant mechanisms need to be developed that facilitate cooperation between the different market players and stakeholders in this process. This will not only deliver the benefits of impact investments in BoP markets but also benefits for society at large. The challenges are systemic and therefore systemic interventions are required. Solutions should be implemented both on the supply and the demand side of the impact investment market. Impact investors met in November 2014 in The Hague and their conclusions are listed below.

Creating a common understanding and moving forward

IB Accelerator
@IBAdventures



Linda Broekhuizen, CIO at FMO: "Inclusive business can only work when we form partnerships and focus on practical solutions." #IBinvest

This and the following Tweets refer to the launch event of the IB Accelerator in 2014.

Most participants agreed that in order to catalyze the development of inclusive businesses, more so-called patient capital (capital with a longer (7 - 10 years) tenor) is needed at lower ticket sizes (€100.000 - € 1 million).

It seems that several impact funds have difficulty meeting these expectations, because this might increase capital risk for these investors. In order to further minimize risk for investment funds, the following solutions were mentioned during the event:

Partnering between funds

Several concerns of investment funds can be taken away when more cooperation and partnering between funds takes place. This not only means promoting more 'club deals' (i.e. the sharing of an investment between several parties) to spread risk, it is also about sharing costs, to improve the balance between rewards and costs of impact investing. For instance, funds can share the costs for due diligence, and other relevant processes in the procedure of assessing and approving investment proposals. Also by sharing deals, the so-called 'search costs' for finding interesting deals can be brought down. As it seems now, there is relatively little cooperation between different funds in the Netherlands. Whereas on an international level this is taking place (Toniic is an example), just as in other development oriented financial sectors (such as the Dutch microfinance platform NPM).

Setting up a pluriform cooperation platform

Even though the impact investing sector is gradually maturing, it is still a young sector, and experience with actual investment projects is often limited. By more actively sharing experiences and best practices, the investment funds can learn from each other.



“Impact investors should do more deals together to share the risk” @elsboerhof #IBinvest #impinv

Platforms should not only be open to investors but also to other stakeholders, such as NGOs. By more actively cooperating with NGOs, investors can bring down the uncertainty that comes with operating in countries where they have little experience and information. In this way, social capital can be shared. NGOs can benefit from such a collaboration when investment capital will flow into the companies with which they work on local programs.

A platform can also help with external profiling. During the event, several barriers in the ecosystem of impact investing have been mentioned, such as tax benefits, providing catalytic capital and the financing of technical assistance. Public actors could play a larger role on this issue than they do right now, but in order to influence decision making on this, joint action through lobbying could help. A platform could serve the function of a lobbying body if it manages to identify common concerns and interests amongst its members.



#solutions “We need one place where we can go to find best practices on IB, but also the failures” #IBinvest

Developing a dual agenda on technical assistance

Technical assistance is not an uncommon practice in impact investing. It is usually focused on the post-investment situation in order to offer a sort of guarantee that the investment will be put to its best use. There is, however, a clear need for pre-investment TA. Experience with impact investors on inclusive business, and the limited experience with many inclusive businesses on building a good (financially sustainable) business plan show that pre-investment TA for both investors and inclusive businesses, can be as important as post-investment TA. Inclusive business is a nascent sector and often investment officers lack the in-depth knowledge of the sector to realize suitable investments. They can be trained to better understand the specifics of inclusive business, including things like the prominence of informal markets, under-developed distribution channels, the importance of focus on basic needs goods, and specific aspects of consumer behavior.

On the business side, the quality of the business plans of many inclusive businesses is below standard. Too little attention is given to the financial assumptions of the

business case, and business models are often underdeveloped. To a large extent, this has to do with the limited knowledge and time that business idea owners have (or take) to develop a proper business plan. Also, many businesses are not aware of what an investor is looking for in a business plan.



“Funding technical assistance for the private sector in developing countries is often seen as ‘not done’. That needs to change.” #IBinvest

Cooperation between funds and civil society

As already mentioned, a closer cooperation between impact investors and NGOs could greatly benefit both. Investors often have limited capacity to assess a local situation in the countries where they intend to invest. This can lead to a higher perception of risk than otherwise might have been perceived. NGOs often do have this local knowledge, as their organizational structure is more deeply embedded in the local context. NGOs might be willing to share this ‘social capital’ with investment funds. As NGOs are increasing their cooperation with the private sector, they are also becoming more keen to facilitate investment in order to boost the effectiveness of their cooperation with local inclusive businesses.

This point also relates to post-investment TA. NGOs do operate several capacity building programs in important inclusive business sectors such as agriculture. These programs could easily also function as post-investment TA interventions for investees. However, quite often impact investors and NGOs do not know about each other’s activities and therefore fail to bring such a cooperation into practice. A good example of how this can materialize is the recent first investment of the Inclusive Business Fund. The IBF works closely with the NGO ICCO. In Uganda, IBF has invested in a coffee company. By providing additional technical assistance (through ICCO) to the coffee farmers (training them on beekeeping as an additional income generating activity) sideselling can be prevented, and hence an important risk in the business case can be avoided.

Supporting more innovative funding mechanisms

Less important in bridging the gap in understanding between investors and IB ventures, but equally important in lowering the risk barriers for impact investors, is the use of more innovative funding mechanisms.

Catalytic funding can bring down the risk for impact investors. Impact investors still shy away from interesting investments where the capital risk is too high. They could, however, be triggered to invest if another party bears a higher capital risk, thus bringing down the capital risk to the investor. Examples of this kind of catalytic funding are

guarantees, subordinated debt or first loss reserves. The question is where this type of capital should come from. Often, public partners (governments, development banks) are seen as the most likely parties to 'subsidize' this kind of capital, but more and more, other parties such as foundations and corporate venturing entities are willing to put up such capital.



[#Finance #solutions](#): Seed funding <1M, blended finance, shared due diligence, first loss cooperation between investors [#IBinvest](#)

Working on long term development of inclusive business investments

Additional developments were identified that could contribute more in the long run to the maturity and efficiency of the impact investment sector. In particular:

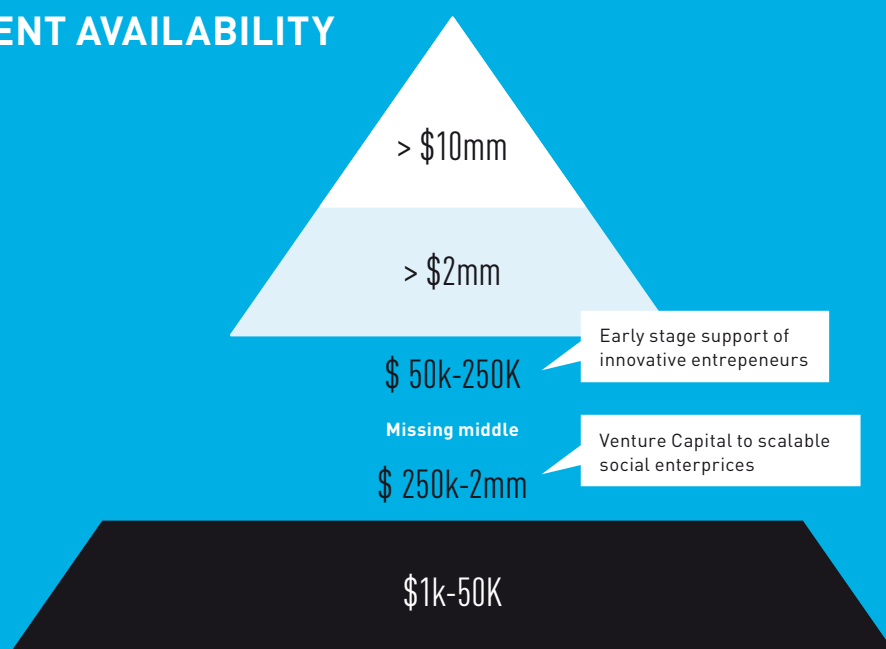
The importance of 'graduation' funds and cooperation along the finance continuum

There are a few investment funds that could be qualified as conducting 'impact investing 2.0'. These funds, such as Acumen, Root Capital, Omidyar Network and LGT Venture Philanthropy, not only provide investments, they also provide grants in earlier phases of inclusive business development, and funding for initiatives that improve the ecosystem for inclusive business. In its publication 'priming the pump'¹, Omidyar Network clearly explains why they take this holistic approach.

These funds provide a financial continuum for inclusive businesses along their venture development pathway. In this way, they 'graduate' along with the fund through the different phases of development; one investor can cover a large part, and in some cases all of the investment cycle. This way of working can avoid the risk that many early stage inclusive businesses encounter: they receive grants, win business plan competitions or challenge funds, but when they are ready for a larger investment, they have to start looking for these investments from scratch. This does not necessarily have to be organized within one entity, such as Omidyar Network does. If the organizations that provide these grants or organize these business plan competitions, are more closely linked to impact investing funds, this 'gap' and the risk it creates, can be avoided.

¹ Bannick, M. Goldman, P. Omidyar Network. Priming the Pump, The case for a sector based approach to impact investing. 2012.

INVESTMENT AVAILABILITY



Defining and understanding impact

Rewards and returns are often understood by investors as financial returns. Financial returns are clear, easy to understand, and they logically relate to investments. However, an impact investor also needs to understand the non monetary returns. This refers to the returns that go beyond the financial return, such as the social or environmental returns.

It is exactly this, that is still difficult to grasp for some impact investors. Much work has been done to develop models and systems to measure this impact, but there is still little consensus. More importantly, it is difficult to relate it to the effectiveness of the monetary investments. In 'development' wording, each inclusive business investment

case could benefit from its own 'theory of change' to make more clear what the expected output/outcome/impact of an investment is. Again, to minimize operational costs, many investment funds refrain from undertaking this exercise for the investments that they make.

But by doing so, they also minimize the potential of understanding the true non monetary impact of their investments, whereas this is often important information for their investors or shareholders.

This challenge also should create more room for innovative funding mechanisms which have a stronger focus on the non monetary impact of investments, such as social impact bonds and program related investments (PRI's).

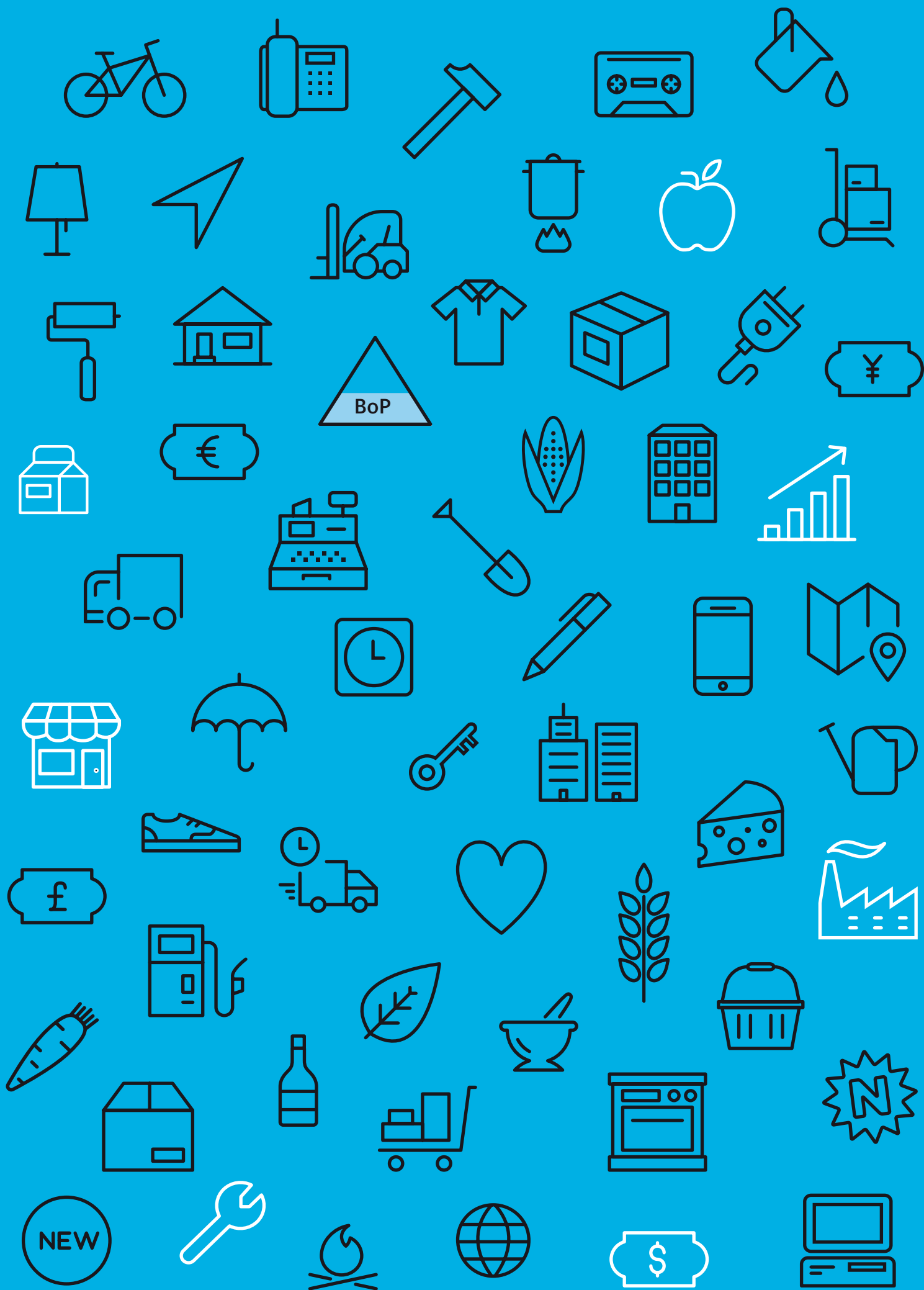
Conclusion

There is a vibrant and resilient private sector that would like to contribute to the wellbeing of people at the Base of the Pyramid by creating job opportunities, and by offering access to quality elementary products and services at affordable prices.

Practical experience reveals a demand for financial support by these companies in the early stages of their innovation trajectories. Currently traditional financial organizations are not sufficiently providing the necessary instruments to support these market based inclusive innovations. In addition, even innovative financing (e.g. impact investing) is still not completely addressing the demand for support at the fuzzy front end of inclusive innovation that requires patient capital in small amounts. Existing impact investing funds show that the success of funding schemes aimed at achieving both financial and social impact at the BoP depends on a combination of business development services, funding and technical assistance services within the fund. This has created a pioneer gap both in time and money between the formation of a firm and the generation of a positive cash flow.

Responses to provide adequate solutions to address this pioneer gap have started to emerge including innovative financial mechanisms and firm venturing at the BoP. From public authorities wishing to invest public capital more efficiently to multinational companies creating a social investment arm alongside their own innovation programmes, a new investment ecosystem is coming into existence. Intermediary organizations have a key role to play in building this ecosystem by providing both a link to social investing and providing firms at the BoP adequate business support to develop innovative BoP products and services.

The challenge of the pioneer gap is clear as is the emerging movement toward hybrid investment mechanisms that provide both finance and adequate business support. This movement holds the promise of being an accelerator for BoP firms, helping them to generate greater impact at the BoP. Over the next decade, these investments and efforts will allow the BoP community to address some of the financial and business challenges that entrepreneurs face when entering BoP markets, and ultimately benefit society at large.





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