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Book

Inclusive business financing : where commercial opportunity and sustainability converge

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INCLUSIVE BUSINESS FINANCING
WHERE COMMERCIAL OPPORTUNITY AND SUSTAINABILITY CONVERGE

JUNE 2018

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Cover photos: (*From left to right*) Farmers arranging freshly plucked red chilies for drying. Inclusive business builds secure and sustainable livelihood (photo by Rakesh Sahai, ADB); A coffee grower collects ripe coffee cherries for further processing. Inclusive business financing enables entrepreneurs and enterprises to participate more effectively in supply chains (photo by Lester Ledesma, ADB); A grape grower collects her produce during harvest season. Inclusive business financing is a powerful development tool to engage the marginalized and commercially-excluded people (photo by Daro Sulakauri, ADB).

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Acknowledgments

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Abbreviations

ADB	–	Asian Development Bank
ASEAN	–	Association of Southeast Asian Nations
BCRBP	–	business correspondent rural banking practice
BOP	–	base of the pyramid
CDC	–	Commonwealth Development Corporation
CSR	–	corporate social responsibility
DFI	–	development finance institution
ESG	–	environmental, social, and governance
GDP	–	gross domestic product
IB	–	inclusive business
IRR	–	internal rate of return
JLG	–	joint liability group
LOFC	–	Lanka ORIX Leasing Company Finance
LOLC	–	Lanka ORIX Leasing Company
MDB	–	multilateral development bank
MFI	–	microfinance institution
MSMEs	–	micro, small, and medium-sized enterprises
NBFI	–	nonbank financial institution
NGO	–	nongovernment organization
PRC	–	People's Republic of China
RBI	–	Reserve Bank of India
TA	–	technical assistance
UHT	–	ultra heat-treated
UNDP	–	United Nations Development Programme
UOBVM	–	UOB Venture Management Private Limited
YES LEAP	–	Yes Livelihood Enhancement Action Program

Currency Equivalents

(As of 1 May 2017)

Currency unit	–	Pound sterling (£)
£1.00	=	$1.37
$1.00	=	£0.76

Currency unit	–	Indian rupees (₹)
₹1.00	=	$0.015043
$1.00	=	₹66.47

Executive Summary

The Report in Context

Since the early 2000s, the constituency of stakeholders focused on reducing poverty and inequality has expanded far beyond governments, donors, and development finance institutions (DFIs). Advances in mobile communications and social media have shed further light on how poverty and inequality arise and why they endure, increase, or abate. These advances have revealed that poverty and inequality affect developed and developing economies alike. They have also highlighted an unanticipated paradox—that current levels of poverty and inequality, as well as strategies to reduce them, imply unsustainable levels of resource consumption. In other words, neither the status quo, nor reducing inequality and lifting 4 billion people out of poverty, is possible in the way that we currently consume (and fail to replenish) capital of all kinds—natural, social, economic, and financial.

More than 1 decade has passed since C.K. Prahalad published *The Fortune at the Bottom of the Pyramid*,[1] a seminal work transforming perceptions of the poor from millstone to market opportunity. Prahalad saw the marginalized and commercially excluded as central to achieving three economic and social objectives: poverty reduction, private sector development, and economic growth. Just as microfinance had proven the bankability of the poor, Prahalad invoked the urgency of "focus[ing] on an active, underserved consumer community and a potential for global growth in trade and prosperity as the four to five billion poor become part of a system of inclusive capitalism" (footnote 1).

This premise proved prescient, as today, many governments and multilateral institutions are seeking consensus-based solutions to socioeconomic and environmental challenges (e.g., the Sustainable Development Goals, COP 21 and 22,[2] and World Trade Organization negotiations) while, at the same time, populist movements and regimes are emerging, debates on climate change are raging, and the disenfranchised are taking to the streets (e.g., the Black Lives Matter, the Occupy, and Arab Spring movements). Also implicit in Prahalad's thesis was that the externalities of exclusion and opportunity of inclusion are obverse sides of the same coin. Inextricably linked, they are, at once, the problem and the solution (or at least, a key part of the solution).

The concept of inclusive business (IB) develops this logic. It expands Prahalad's focus on poor people living at the base of the pyramid (BOP) as consumers by considering their untapped potential as producers, suppliers, distributors, and/or employees. Additionally, it ascribes particular importance to micro, small, and medium-sized enterprises (MSMEs) for two

[1] C.K. Prahalad. 2004. *The Fortune at the Bottom of the Pyramid: Eradicating Poverty through Profits.* Philadelphia: Wharton School Publishing.

[2] The Conference of the Parties (COP) to the United Nations Framework Convention on Climate Change. COP 21 was held in Paris, France in 2015, and COP 22 was held in Marrakesh, Morocco in 2016.

reasons: (i) they generate a large proportion of economic output in developing countries; and (ii) they straddle the formal, semiformal, and informal sectors, they constitute connective tissue that is vital to reducing poverty and inequality. Key to nurturing this connective tissue, or enabling it to be cultivated where it does not exist, is financing.

Rationale for This Report

Given the nexus binding exclusion, poverty, inequality, and resource consumption, this report argues that IB financing matters. In fact, it not only matters; it is urgent for the following reasons.

(i) The externalities of exclusion (i.e., political instability, environmental degradation, social unrest, violence, conflict, and migration) are too great to ignore. Governments and the public sector lack the resources and institutional capacity to arm full responses. In some instances, they can be part of the problem.
(ii) Exclusion perpetuates economic inefficiencies and structural asymmetries. Both have direct and externalized socioeconomic and environmental costs.
(iii) As the political and moral imperative of accelerating inclusion intensifies, and as the question, "If?", cedes to the question, "How?", the scale of solutions needed is becoming clear. It is vast. As such, solutions require the dynamism of the private sector, in partnership with governments and the public sector where effective.
(iv) Similarly, solutions require the agility and resources of the private sector. The challenges faced are interconnected and complex, especially in the context of climate change, rapid population growth, and adverse demographic trends.

The observations above suggest that just as exclusion begets risks, costs, and externalities, achieving inclusion implies opportunities. This makes for a more prominent role for IB financing as an investment and policy tool. At the moment, however, it is a nascent tool with a promising but inconsistent track record in generating positive financial, economic, social, and environmental returns.

There are encouraging developments to be noted. The arena of actors engaged in IB financing is expanding. Capital deployment strategies and investment and lending instruments are evolving. The attention of asset owners, asset managers, and financial institutions has been piqued, and they are gaining experience and sophistication. Nevertheless, the full potential of IB financing remains unrealized. Although stakeholders' expectations of IB financing may differ, there is discernible consensus on three points: more capital is required, the opportunity needs better articulation, and, ultimately, IB financing must be mainstreamed. Hence the timing of this report, which posits four key priorities. First, a clearer understanding of how IB financing occurs is needed. Second, IB financing must be made more effective. Third, to accelerate the growth and deepen the reach of IB, "smarter" IB financing strategies must be developed—innovation and technology are critical in this regard. Finally, many more sources of capital must be attracted (i.e., institutional capital; what might be termed "enlightened capital") to the opportunity and imperative of financing IB.

Analytical Focus of the Report

Section II makes it clear that IB financing is a broad discipline; it incorporates a large swath of investment modalities, business models, company types, and sectors. To be of greatest use to practitioners, this report focuses on two types of capital providers: financial institutions and private equity funds. Section III, which examines financial institutions, takes as its units of analysis individual entrepreneurs, and micro and small enterprises. This is because an appreciation of the trajectory of client capture, retention, and growth is critical to understanding IB-focused product development/implementation. Section IV, which examines private equity funds, concentrates on early growth-stage companies and expansion capital transactions. The focus is intended to help practitioners and the investment community understand the obstacles faced in accelerating aggregation and deployment of IB financing.

The following issues are not covered in depth by this report, although they are frequently referenced.

(i) **Microfinance.** This report does not place emphasis on microfinance, on which reams of literature have already been produced. Many microfinance institutions (MFIs) do provide or evolve into IB financing, and their IB products often incorporate techniques from microfinance, notably group lending. This evolution is, certainly, of great relevance to the report, but traditional microfinance as such is not.

(ii) **Use of inclusive business financing.** Section III is not concerned with personal or consumer financing. Borrowing to meet routine expenses (e.g., school fees, rent, or funeral costs) or larger household purchases (e.g., vehicles and white goods) may constitute financial inclusion but are not IB financing. Such expenditure does not build long-term wealth, nor does it offer a sustainable route out of poverty. By the same token, poverty does not afford clear-cut boundaries between the personal and commercial. Many MFIs and financial institutions accommodate this by assuming or allowing a percentage of lending for pressing personal needs.

(iii) **Loan/investment amounts.** A broad range of loan sizes is considered, from first or entry loans (often group loans) to larger loans made to medium-sized enterprises. In monetary terms, this can range from $2 to $50,000 or more. Large commercial loans of, for example, $100,000 are considered in this report. The reason that the smaller end of the spectrum is highlighted is because loan sequencing is particularly relevant. Loan sequencing shows how financial institutions provide IB financing as they, themselves, innovate and iterate new products. Indeed, a key conclusion of the report is that the most successful IB-focused financial institutions are those where coevolution between the loan provider and its products is fluid and complementary. In the private equity fund context, investment amounts of $500,000 to $10 million are considered; large transactions are considered in this report, although this is not to imply that they do not foster inclusion. It is because funds explicitly pursuing IB tend not to undertake large transactions.

(iv) **Stage of business development.** The focus in Section IV is on growth stage and more mature expansion capital transactions rather than start-ups. Indeed, it seeks to illuminate the perils of funds targeting early-stage deals. Investor demand for such deals is indubitable, but whether young companies are suited to closed-end fund structures is questionable.

(v) **Company profiles.** This report draws a distinction between IB and social enterprises. This is partly for convenience, but it also reflects a significant point. As Section III elaborates, the issue is not that social enterprises are not inclusive; in fact, their social mission can be more explicit than their IB peers. The problem is their prioritization of social and commercial imperatives, and how this jeopardizes fund portfolios.[3]

(vi) **Investment vehicles/modalities.** Section III does not consider angel investment, seed or venture capital, crowdfunding, incubators, or accelerators. Each is complex and nuanced. Some of these pre-investment/investment modalities can be as damaging in some respects as they are constructive in others. Doubtless, they are significant actors in the IB financing landscape, but their promise has yet to be matched by tangible results.

Additionally, Section III considers debt funds rather than private equity funds for two reasons. First, there are far fewer emerging market debt funds than private equity funds, and fewer still focused on IB. Second, private equity funds use numerous investment instruments beyond equity, including basic debt, mezzanine finance, and quasi-equity. This enables incorporation of the salient points of debt financing provided within private equity transactions without studying debt funds. Lastly, in some markets, equity investment is unknown or prohibited.

The sources of capital deployed in IB financing strategies are expanding, and now include donors, DFIs, multilateral development banks, high net worth individuals, foundations, pension funds, sovereign wealth funds, insurance companies, and commercial banks. This report explores four aspects of IB financing that seek to help crystallize achievements made to date and improve future performance:

(i) **Parameters of inclusive business financing.** This report recasts the definition of IB financing and considers the role that the deployment of debt and equity (i.e., how financing is delivered and by whom) plays in fostering entrepreneurship. In addition, the report reevaluates the unique position of the MSME sector in the inclusion landscape with a view to better understanding the role of MSMEs within inclusive supply and value chains.

(ii) **Evaluating the delivery mechanisms.** It also seeks to understand the two main modalities for providing financing to IB—lending by financial institutions, and investment by private equity funds.

(iii) **Analyzing the evolution of inclusive business strategies.** It assesses how financial institutions and fund managers develop, implement, and iterate IB lending products and investment vehicles.

(iv) **Stocktaking and a road map to scale.** This report also undertakes an honest assessment of the current community of asset owners and asset managers, with a view to learning key lessons, drawing practical conclusions from IB financing initiatives

[3] The following definitions of social enterprises illustrate the point. Social Enterprise UK defines them as "businesses…set up to change the world. Like traditional businesses they aim to make a profit but it's what they do with their profits that sets them apart—reinvesting or donating it to create positive social change" (https://www.socialenterprise.org.uk/Pages/FAQs/Category/FAQs). Social Enterprise Mark CIC, also of the United Kingdom, defines them as "businesses with primarily social objectives whose surpluses are principally reinvested for that purpose in the business or in the community, rather than being driven by the need to maximise profit for shareholders and owners" (https://www.socialenterprisemark.org.uk/what-is-social-enterprise/). In the author's view, the second definition conflates profitability with commercial imperative and, crucially, the relationship of the latter with commercial viability. The issue of commercial viability and the implications for IB financing are explored in Section IV.

to date, and identifying future priorities so that IB financing enters the mainstream and reaches scale.

Drawing on case studies of financial institutions, investment funds, and investee companies from across Asia, this report is divided as follows:

Section II. This section develops a detailed definition of IB financing and explores the main characteristics of practitioners, recipient businesses, and beneficiaries. Thereafter, it summarizes the various IB models sought by purveyors of IB financing and how the models realize inclusion. Finally, after outlining the opportunity for financial institutions and funds, Section II establishes clear parameters for the report.

Section III. This section presents six case studies from a cross section of Asian economies to explore how traditional financial inclusion strategies such as microfinance—still the entry point to formal finance for many poor people—act as a conduit to IB financing. This section suggests that leveraging traditional financial inclusion strategies is essential for effective IB financing and that the presence of both MFIs and IB-focused funds in local financial ecosystems can be a significant contributor to IB development.

Section IV. Currently, private equity funds are the most common vehicles for aggregating capital for IB investment. Modeled on fund structures developed in North America and Europe in the 1970s and 1980s, IB private equity funds (commonly referred to as IB funds) seek to generate positive financial, social, and environmental returns for investors. Yet this section reveals that they have a long way to go. Questions remain around fund structures, management teams, and capital deployment techniques. It argues that substantial evolution is needed and that manager attrition is likely before investors consider IB funds as equal peers of traditional funds.

Section V. Using Mongolia as a case study, this section explores how private equity funds and access-to-finance facilities can be synchronized and layered to ensure that each provides appropriate funding to the appropriate recipient. Such a strategy may help solve the issue of using small funds to provide equity to relieve early-stage working capital shortages.

Section VI. The report concludes that IB financing in all forms, although imperfect, is a formidable development finance tool and commercial investment opportunity. It has the potential to become the tool and investment opportunity of choice in the face of the current triple threat of climate change–poverty–inequality. For this to occur, however, capital flows to IB must increase exponentially, which will only happen if a deeper understanding of IB financing is gained and practitioners' track records improve.

1

Poverty and Inequality in Asia

Poverty is multidimensional, involving numerous factors, such as income, social status, socioeconomic position, demographics, purchasing power, degree of vulnerability, security, opportunity, and physical and mental well-being. The World Bank's general definition of poverty as "profound deprivation in well-being" seeks to capture the amorphous mix of factors that challenge the livelihoods of every poor person. With roughly 2 billion of the world's 4 billion poorest people living in Asia, it is especially important to understand the nuanced causes and aspects of poverty.[1]

A. Trends in Inequality in Asia

World Bank data[2] indicate that four-fifths of Asians live in countries and areas in which inequality has increased over the last 2 decades. Indeed, of 30 countries and areas that have comparable data, nearly 50% record increased disparities in expenditure or income per head, as calculated by the Gini coefficient. The Asian Development Bank (ADB) attributed advances in technology, globalization, and market-oriented reforms to major causes of inequality,

Table 1: Consumption and Income Levels of the Top 20% of the Population in Asia, 2009–2014

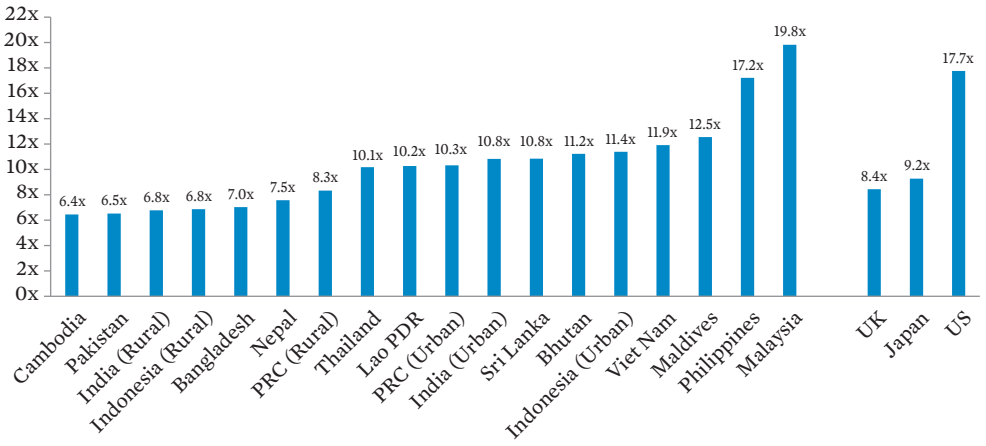
Region	Percentage of Total Consumption and Income
South Asia	43.6
Southeast Asia	46.3
China, People's Republic of	42.9
Asia (aggregate)	44.7
Country	
Philippines	52.7
Malaysia	51.4
Indonesia (urban)	49.5
Cambodia	40.2
Pakistan	40.3
India (rural)	40.6

Source: The World Bank Group. PovcalNet Database. http://iresearch.worldbank.org/PovcalNet/povOnDemand.aspx (accessed 10 August 2017).

[1] This subsection was researched and written by Mark Futers, a graduate of Oxford University and the London School of Economics and Political Science who specializes in international development.

[2] The World Bank Group. PovcalNet Database. http://iresearch.worldbank.org/PovcalNet/povOnDemand.aspx (accessed 10 August 2017).

Figure 1: Ratio of Top 10% to Bottom 10% of Population, 2009–2014



Lao PDR = Lao People's Democratic Republic, PRC = People's Republic of China, UK = United Kingdom, x = times, US = United States.

Source: The World Bank Group. PovcalNet Database. http://iresearch.worldbank.org/PovcalNet/povOnDemand.aspx (accessed 10 August 2017).

largely because they have changed income distribution due to the premium attached to skills leading to reductions in income for unskilled labor. This is also reflected in evolving rural–urban inequality levels.

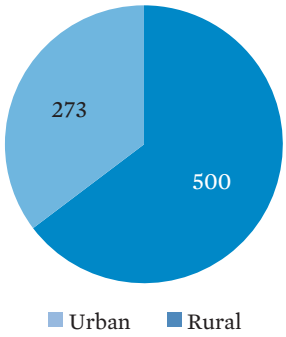
B. Measuring and Comparing Poverty Levels[3]

According to World Bank data,[4] more than three-quarters of Asia's population, some 2.7 billion people, live on less than $8.00 per day. Approximately 1 in 3 (i.e., 1.1 billion people) survive on less than $3.10 per day, and 1 in 10 (i.e., 317 million people) on less than $1.90 per day. While these figures are striking, they tell only part of the story of poverty in Asia, as much variation exists within and among countries and areas. For example, the $1.90 per day rate applies to only 3% of Viet Nam's population, while fully 94% of India's population falls below the $8.00 per day measure. Meanwhile, the People's Republic of China (PRC) has nearly twice as many rural poor as urban poor, despite the majority of the population living in urban areas (Figure 2). As a result of buoyant gross domestic product (GDP) growth in the PRC in recent years, the largest share of Asia's poor now resides in South Asia, a trend amplified at more extreme levels of poverty, in other words, particularly below the $1.90 per day level (Figure 3).

[3] The most recognized benchmark for measuring poverty and making comparisons is the World Bank's international poverty line of $1.00 per day. This figure is updated periodically, most recently reaching $1.90 per day in October 2015 at 2011 purchasing power parity. This represents the value of consumption required to meet a person's most basic needs, such as obtaining shelter or eating sufficient amounts to avoid starvation. Other common poverty demarcations include $3.10 per day (i.e., formerly the $2.00 per day line) and $8.00 per day.

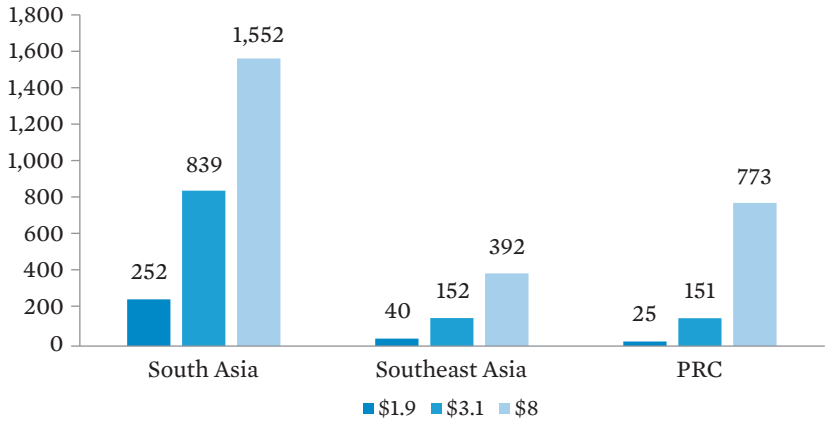
[4] All data in this paragraph are sourced from http://research.worldbank.org/PovcalNet/povOnDemand.aspx (accessed 10 August 2017).

Figure 2: Population Living on $8.00 per Day or Less, People's Republic of China
(million)



Source: The World Bank. PovCalNet.http://iresearch.worldbank.org/PovcalNet/povOnDemand.aspx (accessed 10 August 2017).

Figure 3: Comparative Poverty Indicators in Selected Regions in Asia
(million)



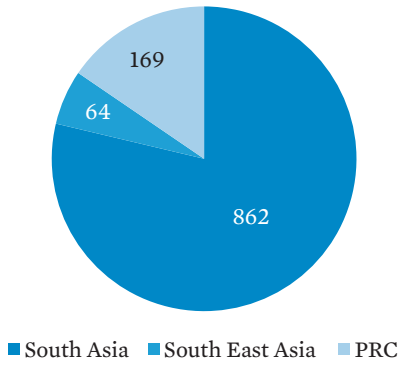
PRC = People's Republic of China.
Source: The World Bank. PovCalNet.http://iresearch.worldbank.org/PovcalNet/povOnDemand.aspx (accessed 10 August 2017).

While such figures offer a sense of the poverty landscape in Asia, it is important to note that the daily United States dollar amounts are simple monetary averages of the value of consumption. They do not incorporate the variability and unpredictability of income flows experienced by the poor. Informal workers may have only intermittent employment opportunities, or farmers may see months pass between harvests. Both struggle to plan for the future, owing to an acute lack of certainty and security.

Poverty lines represent a purely monetary conception of poverty, whereas human deprivation is multifaceted. The Multidimensional Poverty Index of the Oxford Poverty and Human Development Initiative incorporates several indicators of deprivation that cover three

primary dimensions of poverty: health, education, and living standards.[5] According to this methodology, about 1.1 billion people in Asia are deprived, or poor, again with a notable majority found in South Asia. The initiative also differentiates those living in extreme poverty from those in poverty, while the vulnerable are identified as a separate category meriting attention. Although many poor people may be born into and remain trapped in poverty, it is important to recognize that poverty is dynamic, and that the near-poor must also be prevented from slipping into or back into deprivation.

Figure 4: Population in Multidimensional Poverty
(million)



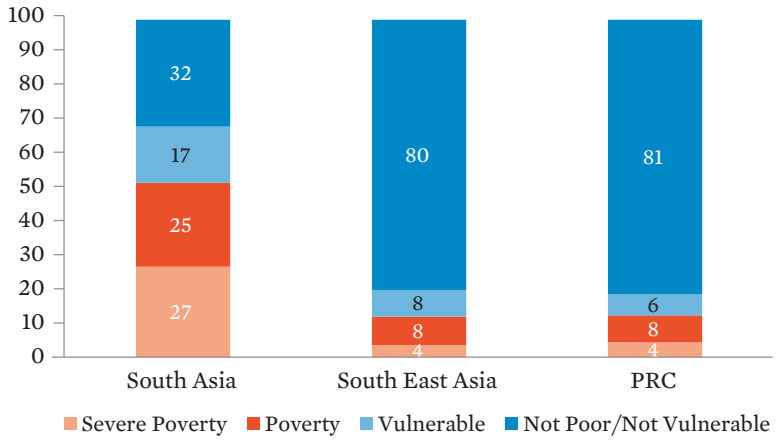
PRC = People's Republic of China.

Source: S. Alkire, A. Conconi, G. Robles, and S. Seth. 2015. Multidimensional Poverty Index, Winter 2014/2015: Brief Methodological Note and Results. *Oxford Poverty and Human Development Initiative (OPHI) Briefing 27*. Oxford, UK: University of Oxford. http://www.ophi.org.uk/wp-content/uploads/MPI-2015-Brief-Methodological-Note_1-5-15.pdf?0a8fd7.

[5] Examples include child mortality, years of schooling, and access to electricity.

Figure 5: Multidimensional Poverty in Asia
(%)

A.



PRC = People's Republic of China.

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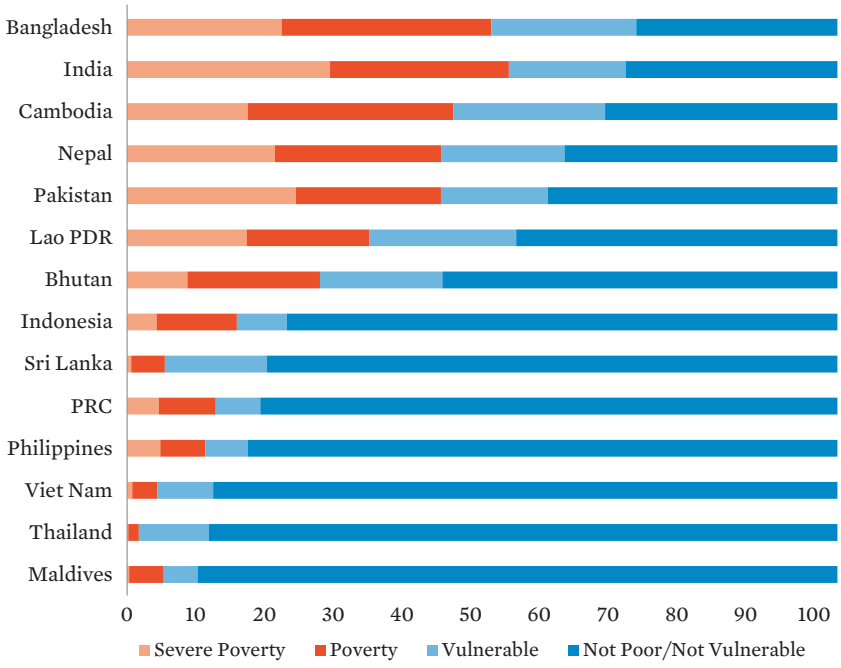
B.



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Source: S. Alkire, A. Conconi, G. Robles, and S. Seth. 2015. Multidimensional Poverty Index, Winter 2014/2015: Brief Methodological Note and Results. *Oxford Poverty and Human Development Initiative (OPHI) Briefing 27*. Oxford, UK: University of Oxford. http://www.ophi.org.uk/wp-content/uploads/MPI-2015-Brief-Methodological-Note_1-5-15.pdf?0a8fd7

II

Defining the Inclusive Business Opportunity in Asia

A. Understanding Inclusive Business Financing

This section establishes working definitions of inclusive business (IB), IB financing, and financial inclusion. Clarity is vital here for two reasons. First, use of the terms ranges from the academic and precise to the colloquial and wide-ranging. Some have acquired general connotations. For example, many associate financial inclusion or access to finance with banking the unbanked or underbanked. Although this is often an accurate description, the term can denote a broader range of activities. Second, the scope of this report is specific: it is about financing IB, or how financial institutions and funds channel capital to IBs for them to grow. It is written from the vantage point of the capital-deploying institution or entity; thus, there can be no confusion about the activity being undertaken. As such, distinctions must be made among IB, IB financing, and financial inclusion, while recognizing the relevance of their interrelationships.

(i) **Inclusive business.** An IB is one whose model enables individuals, households, entrepreneurs, and micro, small, and medium-sized enterprises (MSMEs) to gain access to affordable goods and services that are vital to meeting basic needs; building secure, sustainable livelihoods; and engaging more effectively and fully in supply and value chains in enduring and beneficial ways.

(ii) **Inclusive business financing.** IB financing is the provision of capital by a financial institution, nonbank financial institution (NBFI), or investment vehicle, such as a private equity fund,[6] to an individual, entrepreneur, or MSME to start or expand a business that addresses one or several aspects of exclusion with a commercial strategy; facilitates inclusion of the recipient of capital in a supply or value chain as a producer, supplier, distributor, and/or employee; and/or enables the poor to increase production or to pursue economic opportunities that increase their incomes and security. IB financing also refers to the process of designing and implementing IB products by financial institutions or IB investment strategies by fund managers. It is often accompanied by advisory services or technical assistance (TA), especially in the case of private equity funds.

(iii) **Financial inclusion.** This term refers to traditional access to finance; in other words, making available financial services, such as loans, bank accounts, or insurance, to anyone excluded on the basis of geography, gender, religion, literacy, documentation, informality, lack of assets, or any other exclusionary criterion or dynamic. It implies the establishment of a relationship where one previously did not exist between an individual and a microfinance institution (MFI), financial institution, or NBFI

[6] This is not to suggest that other sources of IB financing do not exist. Numerous large corporations, especially those engaged in agriculture or agro-processing, finance IB as a way of securing a consistent supply of key primary goods. Such IB financing and engagement strategies are not, however, the focus of this report.

Box 1: The ADB Definition of Inclusive Business

An inclusive business (IB) is a business entity that generates high development impact by improving access to goods and services for the base-of-the-pyramid population (i.e., low-income people); and/or providing income and/or employment opportunities to low-income people as producers, suppliers, distributors, employers, and/or employees. An IB must be commercially viable (i.e., it must meet nonsovereign operation standards of viability). It can be a stand-alone business entity, or a business operation of a larger business entity. Project design advances are excluded from the computation.

Source: ADB. 2017. *Standard Explanatory Data Indicator Definitions*. Manila. https://www.adb.org/sites/default/files/institutional-document/33903/standard-data-definitions-may2017.pdf

(e.g., a savings and credit cooperative or a nongovernment organization [NGO]). This said, the meaning of financial inclusion is richer than a simple before-and-after scenario (i.e., Before engaging with a financial institution, Person A could not borrow, after Person A has a loan). In extending financial services, it suggests that a lender perceives there is a bankable opportunity resulting from a gap in the market or a market failure. This perception drives product design and rollout strategies.[7]

Intensive engagement with governments by ADB and its development partners has led to important policy initiatives and, in some cases, regulatory changes to create an enabling environment for IB financing (Box 2).

The relationship between access to financing and IB financing is relevant. Many financial institutions begin by providing access to financing (e.g., loans, credit, and bank accounts) and financial services (e.g., insurance products, overdraft facilities, and working capital facilities), then evolve into providing IB financing. Others use financial inclusion as an onboarding mechanism to enable client capture and establishment of a credit history. It is in this sense that financial inclusion is explored in this report—as a foundational, market-building practice. Indeed, in many instances, this initial engagement serves as a gateway to IB financing as clients' needs evolve over time.

In the case of private equity, funds make investments into financial institutions or MFIs to gain exposure to the underlying financial inclusion and/or IB financing strategies. Investment teams assess the past performance and future prospects of the target investee (i.e., the financial institution). Naturally, these reflect the institution's current and future product offerings and overall strategy.

[7] The extent to which social mission features in this perception varies by provider. The case studies in Sections III and IV shed light on the merits of allowing social mission to drive strategy and product development.

Box 2: Toward Conducive Inclusive Business Policy Platforms: India, Indonesia, and the Philippines

India. India has a very active inclusive business (IB), social enterprise, and corporate social responsibility (CSR) movement. Large sums of CSR funding are available under legislation that mandates corporations to allocate 2% of profits to CSR. The CSR funds are currently being pooled, while more strategic IB investments are being sought. It is estimated that 6,000 Indian companies will be required to undertake CSR projects to comply with the new guidelines, meaning that CSR spending, including IB-related activity, could total $2.7 billion per year in India.

Indonesia. In 2016, the Government of Indonesia initiated work on IB accreditation and policy alignment. It is considering the establishment of a high-level IB and social enterprise task force under the Office of the President in the Coordinating Ministry for Economic Affairs. Indonesia also has a CSR law mandating large companies to invest 2% of their pre-tax profits into activities that benefit the poor and the environment. As in India, companies and provincial governments are exploring how to deploy such funding in more strategic, inclusive commercial strategies. Two prominent business councils, the Indonesian Chamber of Commerce and Industry (KADIN) and Employers' Association of Indonesia (APINDO) are looking to promote an IB agenda through knowledge-sharing and other activities.

Philippines. The Philippines is the most active promoter of IB in Asia by far. The government is currently establishing an IB and social enterprise accreditation system through the Board of Investments under the Department of Trade and Industry. The system will be based on a composite rating tool developed through a partnership between government and business associations. Rating criteria include the business case (35%); social impact (50%), assessed by reach (i.e., scale and targeting), depth (i.e., extent of improvement), and systemic change contribution; and innovation to solve social and environmental problems (15%). The validation of IB business models, which can be discrete operations within companies, is conferred after third-party validation. Initial accreditation has been piloted with 25 companies in the agribusiness, tourism, and housing sectors.

The government has also identified IB as a strategic imperative under its investment priorities plan (IPP), which triggers prioritization of accredited IB for industry support programs. The 2017–2019 IPP, approved by the Office of the President in February 2017, aligns with the 10-Point Socioeconomic Agenda of the Duterte Administration and seeks to scale small enterprises and disperse economic opportunities to underserved regions. Under the IPP, IB may qualify for "pioneer status," which entitles them to up to 5 years of income tax holidays.

Sources: Government of the Philippines, Board of Investments. *IB in the BOI Investment Priorities Plan 2017–2019*. http://inclusivebusiness.boi.gov.ph/boi-initiatives/ib-in-the-ipp/; and Inclusive Business Action Network (IBAN). The Practitioner Hub for Inclusive Business. http://www.inclusivebusinesshub.org/.

B. The Meaning of "Inclusive" in Inclusive Business Financing

The term "inclusive" in IB financing is more significant than it may appear. It denotes an objective, imperative, investment approach, and focus on a particular business model. It implies a view of financing in the economy and society, as well as a relationship between the purveyor and recipient of financing that transcends the monetary to encompass the developmental. This is because positive outcomes are anticipated for key stakeholders, principally the funding recipients and beneficiaries of their businesses. Similarly, commercial opportunity is perceived as the driver of such outcomes.

Indeed, the case studies in this report suggest that the success of an IB lending or investment strategy is, in part, a function of how evolved the investor's understanding of "inclusive" is in IB financing. There are several aspects to this:

(i) **Deliberate focus and clear intent.** The financial product or fund must deliberately focus on excluded, marginalized, or underserved individuals, entrepreneurs, groups, or communities; or on companies serving them with an IB model. Often, this is expressed as a focus on the poor, lower-income groups, or those living at the base of the pyramid (BOP). The purveyor of financing must intend to engage with them directly because there is a compelling business case to do so. In this sense, the financing and process of inclusion are both the means and the ends.

(ii) **Commercial rationale.** The above intent should not be misinterpreted as a proxy for a social mission, however. It does not indicate that social impact is being prioritized over financial return. On the contrary, just as there must be a clear commercial rationale for a financial product or fund strategy, the target borrower (i.e., an individual or MSME) in the case of debt, or an investee company in the case of equity, must be viable, or expected to become so, as a result of the financing.[8]

(iii) **Intrinsic inclusion.** Inclusion must be intrinsic; the commercial opportunity must reside in realizing the inclusion strategy of the individual or business to be financed, and it must be embedded in the productive endeavor. Contrast, for example, a company that offers child-care facilities for employees with a company whose business provides affordable child-care facilities to low-income workers. The former is a favorable employment policy, while the latter is a business model.

(iv) **Linkages.** Both the financing provider and recipient must see commercial opportunity in the outputs and outcomes that result from inclusion. These include creating business linkages where they do not exist, repairing dislocations in supply chains and value chains, or recalibrating them to enable opportunity. Although financial institutions, funds, borrowers, and investee companies may not use the language of development financing, it is borne out in what the financing achieves, whether facilitating a last-mile solution or diversifying a supply base to incorporate and hence benefit the poor.

[8] There is nothing wrong with a financial institution or fund seeking to improve people's lives. However, this report suggests that it becomes problematic when it compromises commercial viability. An important distinction is being made between commercial viability and profitability. For a detailed discussion of the hazards of putting social mission before commercial viability, see Section IV.

C. Inclusive Business Engagement Models

IB gained currency among development finance practitioners in the early to mid-2000s. Although it suggests a perspective on the socioeconomic position and potential of an individual, group, or business, few IBs self-identify as such, and not all financial institutions label their products as explicitly inclusive (e.g., they may come under the purview of a financial inclusion department or responsible banking unit). For most IBs, business is business—a commercial endeavor responding to a market opportunity. For individuals or microenterprises at the BOP, it is survival.

Conversely, those providing financing to IBs do present themselves as IB or impact offerings, seeking to achieve positive social and/or environmental outcomes. Of intermediaries providing IB financing, funds are most likely to be labeled as IB funds or impact investment funds with a focus on IB. Some providers of wholesale financing, especially development finance institutions (DFIs) and multilateral development banks (MDBs), do this as well, prioritizing certain business drivers and characteristics and harboring extrafinancial expectations alongside financial returns (e.g., improved access to key goods and services). It may be said that they project onto the financing recipients a set of desired outcomes and impacts, but this can bear heavily on the relationship among IB financiers, financing recipients, and investors in IB financing strategies.

How, therefore, do investors, funds, and financial institutions identify IBs? Furthermore, what constitutes an IB financing opportunity? Two features distinguish IB financing opportunities: the IB engagement model, and the beneficiaries of the IB.

1. Inclusive Business Engagement Models

IB is generally categorized by an engagement model: consumer, producer, supplier, distributor, and employee.[9] Each model posits an actor or stakeholder, such as a consumer or producer, in relation to the business. Hence, a consumer-focused IB model targets excluded consumers, and a distributor-focused IB model utilizes overlooked or marginalized BOP incumbents as distributors of a good or service. The boundaries between engagement models are not always clear-cut, however. Some IBs involve various dimensions of engagement.

The business models are presented from the perspective of the IB financier in this report, such as the financial institution, fund, or other intermediary lending or investing. This is because the way in which financiers distinguish different financing opportunities must be understood.

Consumer-focused inclusive business model. These IBs provide goods and services that enable the poor to overcome fundamental obstacles or challenges. There are two kinds of challenges: primary and compounded. Primary challenges include first-order obstacles like lack of access, physical distance or danger, limited availability, unreliability, high cost, poor quality, or limited choice. Compounded challenges are multidimensional; for example, a service becomes available online, but the consumer has no power, internet connectivity, or understanding of how to access it. Access to the service is not possible; consequently, the consumer is either overlooked or a

[9] Many practitioners consider producer and supplier models together owing to their similarities. This study does the same.

compound solution is required. All of these challenges constitute a "poverty penalty," which is an obstacle, cost, or effectively, regressive tax that derives from being poor.

The salient feature of this IB model is that there is a commercial opportunity in overcoming the obstacle (i.e., money to be made in removing or reducing the poverty penalty). The success of the model depends on the presence and intensity of IB viability drivers, which are a mix of financial, physical, geographical, social, and cultural factors that drive the consumer responses of the poor. For example, a simple viability driver is the availability of clean water at an affordable price and practical size. A more complex viability driver is the appearance of a day care center in a densely populated urban center. In the first instance, it must be affordable and convenient, and be perceived as safe and reliable. In addition, however, market, street, or alleyway chatter must confirm that the day care is, for example, value for money and that children are learning and content. The complexity resides in the need for the service to gain sociocultural endorsement or, metaphorically, license to operate.

Another important feature of this model is that growth and inclusion must be mutually reinforcing. In the water example, the more clean, affordable water sold, the higher the revenue and greater the health and livelihood security of those consuming it. In the day care example, the more entrenched and valued the service, the more clients and the greater the revenues (and, importantly, the better the outcomes for poor urban children).

What attracts the IB financing provider to consumer-focused IBs? Does due diligence consider additional criteria beyond standard financial and product analysis? The answer is yes, and the criteria depend on the prospective borrower or investee:

(i) **Cost elasticity of inclusion.** This considers the degree of inclusion achieved (i.e., the inclusion quotient) relative to production cost, which is the ability to lower cost and to achieve affordability without compromising other IB viability drivers.
(ii) **Price elasticity of inclusion.** This is the strength of the IB viability driver relative to the price to the consumer.
(iii) **Cash-flow elasticity of inclusion.** This is the extent to which the good or service accommodates the cash-flow volatility and daily livelihood insecurity experienced by the poor. Two dynamics are at play here: the sensitivity to, and understanding of, such measures by the producer of the good or service; and the sensitivity of the consumer. The more dimensions of exclusion addressed by the good or service, the greater its likely appeal.

The private equity investor will evaluate these factors more frequently and in more detail than the loan officer. However, a good financial institution product design team will analyze them thoroughly prior to piloting and launching a product.

Producer/supplier-focused inclusive business model. These are businesses that source, or seek to source, unfinished or semifinished goods from the poor (e.g., raw materials or cash crops). In some cases, such businesses deliberately seek to increase the number of lower-income or BOP producers or suppliers from whom they source to secure a reliable, consistent, quality supply of important inputs. Such businesses thus draw in poor people to supply chains and, in some cases, value chains (Box 3). The stability afforded by inclusion in a supply or value chain reduces the vulnerability of the poor to daily cash-flow variations or exogenous shocks. Companies benefit because consistent, reliable, better quality supply enables them

Box 3: The Relevance of Supply Chains and Value Chains to Inclusive Business Financing

A supply chain is the relationship and network between a company and its suppliers to produce and distribute a good or service. The supply chain represents the steps taken to provide the good or service to a customer.

A value chain refers to the participants engaged in bringing a good or service to a customer, and the successive stages of value addition that are undertaken along that trajectory.

Inclusive business financing enables entrepreneurs and enterprises to participate or to engage more effectively in supply chains and value chains, thereby helping repair dislocations in, strengthen, and/or enable their creation where they are absent.

Source: Author's definition.

to plan more effectively and to grow. In this sense, the producer/supplier-focused IB model binds the demand side and supply side in a win–win situation, that is, the commercial (the business) with the individual (the producer/supplier).

The rationale for engagement is critical to the integrity of this IB model. Practitioners must make a clear distinction between genuine producer/supplier-focused IB business models that necessarily engage the BOP, and corporate social responsibility (CSR).[10] This model engages with BOP producers/suppliers because it is in the companies' commercial interest to do so, as the need to incorporate poorer producers/suppliers derives from the characteristics of the supply or value chain. For example, a chocolate company in Indonesia may engage with thousands of poor cacao farmers because it requires access to the raw material to produce cocoa products. The engagement is an intrinsic dimension of the company's operations, not an additional, adjacent, or consciously socially responsible initiative.

The relationship between the company and the producer/supplier may extend beyond sourcing and purchasing to incorporate activities such as training and systems implementation; technology transfer and know-how to improve production techniques; sector expertise (e.g., in agriculture, specific crop-related education or training in use of fertilizer or pesticides); access to key information (e.g., prices, market-related data, or weather forecasts); and access to financing by brokering relationships with financial institutions, or establishing a credit cooperative to aid the purchase of key inputs (e.g., seeds, equipment, and fertilizer). In some cases, the financing is provided as credit by the company itself.

The reason this is done is because the company recognizes that investment in its producers/suppliers—financial, nonfinancial or both—is needed to secure consistent supply of quality goods. Such investment should not be mistaken for altruism. It represents commercial self-interest that may generate positive externalities to the producer/supplier beyond the opportunity to produce for a reliable offtaker and income growth.

[10] In contrast to the producer/supplier-focused IB business model, the prime motivation for a CSR strategy is not commercial, although it may have commercial benefits for a business. CSR generally reflects the pursuit of intangible priorities related to branding, marketing, reputation, and market perception. CSR strategies are usually pursued by large corporates and can be controversial. In some cases, it is suggested CSR is used to whitewash core activities or their true motivations, or to divert attention from damage done or likely to be done.

Depending on the size of the business and its planning horizon, its degree of engagement with producers/suppliers can be far greater than expected. For example, a large agro-processing company may conclude that, having improved the quality and reliability of a crop supply, it is in its interest to build a warehouse or a refrigeration facility. To the extent that suppliers/producers contribute to the cost of construction, or pay for use of the facility once completed, this can help cement even closer ties between the demand and supply sides.

The IB financier must assess several aspects of producer/supplier-focused IB models with care, notably:

(i) **Rationale for engagement.** The stronger the commercial imperative to engage, the greater the likelihood of success. Contrast, for example, a rice processor that needs to increase the supply of quality rice in response to strong demand, hence increasing the number of rice farmers in its supply chain, with a coffee-roasting company that increases suppliers of raw beans to reduce risk by diversifying supply. The latter may be a prudent risk mitigation strategy but, perversely, the management commitment may wane unless a discernible risk event materializes that proves value for money of deeper engagement.

(ii) **Costs and barriers to engagement.** The relationship between the intensity of engagement with producers/suppliers required by the business model and the costs, both financial and nonfinancial, must be evaluated; that is, IB financiers must consider the cost elasticity of producer/supplier engagement. They must assess the viability and profitability of the business model against the expenditure needed and challenges specific to the engagement of current and new producers/suppliers for the business to succeed. Business models must be optimized to take account of high transaction costs, aggregation, formation of cooperatives, training, and technology transfer. Further, the company may have to resolve infrastructure challenges (e.g., poor roads or unreliable power supply). If producer/supplier engagement is cost-inelastic (i.e., the company must engage with given producers/suppliers to be in the business it is in), the IB financier must evaluate the risks and variables affecting the reliability of that engagement. If producer/supplier engagement is relatively cost-elastic, the company has more options in response to the risks and variables of engagement.

(iii) **Extent of engagement.** One critique of this model is that any financial or extrafinancial outlay made by the financier is a subsidy. Another is that it creates dependence that can lead to exploitation. Thus, the IB financier must interrogate the business model to ensure that engagement beyond the loan or equity investment is proportional and, ideally, time-bound. Where possible, interests should be aligned through cost-sharing, either at the front-end (i.e., the company and producers/suppliers each cover a percentage of the outlays) or back-end (i.e., the company deducts the cost from the price paid for inputs over time). In many cases, funds and financial institutions draw on TA funding to cover the costs, or look to NGOs to provide capacity building. However, putting distance between nonfinancial engagement and the commercial needs of the business can compromise its effectiveness, and many NGOs lack the investment and business development expertise to be helpful to the business.

Many lower-income producers and suppliers struggle to access financing. Contributing factors include limited or no collateral, lack of credit history and financial records, and perceived sector risk, particularly in agriculture. Therefore, many businesses whose models necessitate engagement with BOP producers/suppliers are involved in resolving such challenges. The

motivation, however, must be to facilitate access to financing for commercial ends, not to subsidize or simply to help.

Finance provision by inclusive business. In cases in which a company develops close relationships with producers/suppliers, and has a clear sense of the importance that they, their households, and communities attach to the commercial opportunity, it may choose to provide financing itself. This can take the form of periodic cash advances for key inputs (e.g., seeds or fertilizer), working capital advances, term loans, or credit. The advantages of this approach are twofold: the IB and its producers/suppliers both have intimate, complementary knowledge of the challenges; and they are aligned in resolving them. However, the IB must recognize the hazards. It is a business, not a bank. Managing expectations can be delicate. Managing payments, collections, and record keeping takes time and money. Further, the company must stick to commercially motivated problem solving—that is, no cash, no seed purchases by farmers, no crops produced. Blurred lines cause expectation gaps that can quickly sour relations.

Externally sourced financing. Some companies opt to outsource solutions by establishing relationships with an MFI, NBFI, or NGO on behalf of individuals, communities, or cooperatives. In such cases, the provision of financing is a function of the volume of demand to which producer/supplier output responds, itself a reflection of the company's track record and growth prospects.

How does the IB financier perceive producers/suppliers? Must they be poor, low-income, or BOP incumbents? Is this relevant? Are these, or should they be, criteria in lending and investment decisions? All stakeholders—producers/suppliers, IBs, and IB financiers—are best served when commercial criteria drive decision making. This is not to suggest that owners or managers whose motivations go beyond the purely financial should be avoided; rather, the business model must do the doing. Commercial success must at once be predicated on, and deliver, social or environmental change. Some companies may be in a position to incorporate particular producer/supplier groups that reflect their noncommercial values or priorities. An example is an IB that uses prison labor, training inmates, helping them save wages, and choosing to employ them upon completion of their sentences. Provided this focus is an integral part of the business model, it is not uncommercial and may even be a value-driver in the market.

Distributor-focused inclusive business model. This model incorporates the BOP as distribution agents—women, men, traders, small vendors, retailers, delivery personnel, and motorbike (or rickshaw or *tuk-tuk*) owners. Practitioners often cite the importance of this model as solving the last-mile delivery problem. In this sense, distributor-focused IB engagement models often solve for multiple challenges posed by exclusion. An affordable, quality good or service may be unavailable because the provider is unable or fails to devise a strategy to overcome distribution challenges. Such challenges can be physical (e.g., narrow alleyways in slums preventing access for delivery vehicles), infrastructural (intermittent energy supply), or virtual (e.g., supply or internet connectivity impeding access to as service delivery).

Anecdotally, distributor-focused models are the least frequently encountered of the three discussed, but their inclusion quotient is high because the distributors double as the means and ends of inclusion. In other words, inclusion derives from the incorporation of the poor

as distributors, enabling them to be economically active and income generating, and the availability of goods or services as a result of the delivery resolves the last-mile challenge.

In the developing world, engagement of IB distributors, especially women, has become a familiar business model for scaling delivery of certain products. Solar lanterns and cookstoves are well-known examples. However, the full potential of the distributor-focused model is only being realized as technology evolves and internet connectivity improves. They enable business models that specifically seek to solve compounded inclusion challenges. To put it in another way, they enable entrepreneurs to move from addressing a single vector of inclusion (e.g., affordability) to inclusion on multiple axes (e.g., availability, delivery, and affordability; see Box 4).

Employee-focused inclusive business model. Such businesses generally employ large numbers from the BOP (e.g., factory workers). Some practitioners see little distinction between the employee-focused and distributor-focused IB models, because both use low-income labor. This report does not concentrate on employee-focused IB models because they often mistake sensible health and safety, employment, and social policies for the transformative change implied by an IB model. Paying employees respectable wages and providing clean, safe work environments make good business sense, apart from usually being a requirement under local and international labor laws. In addition, training may be provided because staff need to be trained to produce a good or service. Such initiatives have many benefits, from increasing staff loyalty and productivity to mitigating risks and reducing costs, but the opportunity to work for a respectable wage or the presence of a staff canteen or on-site nurse does not denote an IB strategy, solely a business practice. Moreover, employment—the opportunity to be economically active—is itself inclusive. Yet while inclusive in a basic sense, the employment itself is not necessarily transformative from a business model perspective.

The employee-focused IB engagement model must, in contrast, be transformative for the poor by enabling them to overcome one or more aspects of the poverty penalty that they face. Hiring employees of a particular gender or ethnic group can be examples, but it is not clear if this constitutes an IB model. It may reflect the owner's background or social disposition or may be due to the abundance of one labor pool over another. In either case, the outcomes are positive, but whether there is a discernible business model driving change is questionable.

2. Beneficiaries

The second component of an IB financing opportunity is the composition of beneficiaries. There are two kinds of beneficiaries: recipient and agency. Recipient beneficiaries are people whose livelihoods are improved as a result of a good or service being made available by an IB (e.g., affordable clean water, or access to convenient, affordable health care services). Agency beneficiaries are people whose livelihoods are improved by the opportunity to engage with an IB in an economically active manner (i.e., the agency afforded them by the opportunity to produce, supply, or distribute goods and services). The two beneficiary types are not mutually exclusive; they can be complementary (e.g., a low-income woman who, through the purchase of a clean cookstove, becomes a product distributor).

The purpose of identifying beneficiaries may, at first, seem anecdotal (i.e., lenders or investors looking to understand which groups are benefitting from a company's goods or services or inclusive financial product). Certainly, there is strong demand for beneficiary narratives, or

Box 4: A Distributor-Focused Inclusive Business in Viet Nam

OkieLa is an online consumer marketplace that connects buyers and sellers in Viet Nam. It solves logistics and distribution challenges through delivery and collection points. Focused on the micro and small trader segment, mom-and-pop shops, and informal vendors, OkieLa creates commercial opportunities particularly for lower-income groups through a platform that solves last-mile delivery challenges.

The company selects proprietors whose shops become delivery and collection points for goods bought and sold though OkieLa. In so doing, OkieLa effectively organizes and helps systematize, if not formalize, commerce at the base of the pyramid and adjacent low-income socioeconomic segments. In this way, it essentially democratizes access to the marketplace and hence income-earning opportunities.

Having successfully launched several companies, OkieLa's founders sought to solve perennial delivery challenges in Viet Nam through an inclusive business model. They recognized that micro, small, and medium-sized enterprises (MSMEs) account for over 90% of businesses in Viet Nam, yet remain largely excluded from opportunities generated by rapid developments in e-commerce and changing consumer/vendor behaviors in response. Hence OkieLa developed an inclusion strategy to harness vibrant commerce and entrepreneurial drive across all demographics to achieve impact at scale.

With a population approaching 100 million, three observations about Viet Nam led the founders to create OkieLa. First, in their own words, "you need to be selling something in Viet Nam to survive, but there is no platform." Second, Vietnamese commerce among lower socioeconomic echelons is beset by the high cost and inefficiency of logistics and distribution. Third, Viet Nam has bypassed personal computers and jumped directly to smartphones. From the founders' perspective, the communication and exchange channel was there, the medium was there, the critical mass of demand was there, but the mechanism—or marketplace—was missing.

OkieLa solves for the problem of online sales for MSMEs, as well as purchase and delivery. It connects microentrepreneurs to a far larger market of consumers, facilitated by OkieLa's electronic platform, payment, and point-to-point delivery solution. Until recently, Viet Nam only had a classifieds model, through which sellers listed goods for buyers, but transactions tended not to occur because the connection between buyer and seller began and ended with the classifieds list. Many sellers used a "bait and switch" method; that is, they either did not have the product advertised or they had different goods, listing the desired goods simply to attract customers. Transport and delivery costs are also very high in Viet Nam, and sellers generally do not want to pay for shipping. Deliveries often go missing because fixed or clear addresses are not always available, and theft is also a problem.

Having experimented with an alleyway delivery model, where the founders themselves tried to locate addresses in Ho Chi Minh City by bicycle based on what was listed, they realized that establishing delivery and collection points must solve the last-mile delivery issue; and drive much-coveted traffic into small shops, particularly the mom-and-pop segment. OkieLa's business model thus identifies partner proprietors whose premises

continued on next page

Box 4 *continued*

double as delivery and storage point for goods purchased online. Earning a percentage on each package, shop owners can handle up to 100 packages or more per month, depending on storage capacity. Importantly, this draws additional foot traffic to shops, affording OkieLa partner proprietors a competitive advantage over other businesses in their alleys or on their streets. Thus, partnership with OkieLa represents a complementary income-generating opportunity for shop owners.

While OkieLa is open to all market segments, it focuses on the lowest three business tiers:

Tier 1. Established, formal businesses, usually family-owned, that pay taxes and generate approximately $1,000 per month.
Tier 2. Semiformal businesses, paying little or no tax, turning over roughly $300–$500 per month.
Tier 3. Mom-and-pop shops and small premises in the informal sector generating $100–$200 per month.

Three-quarters of OkieLa's businesses are in the Tier 3 segment.

OkieLa shows how the technology-enabled channeling of commerce creates opportunities for small traders who live precariously on daily cash flows. Furthermore, its business model is creating value-addition opportunities, especially for Tier 1 and Tier 2 shops. For example, some shop owners are purchasing basic goods such as tee shirts, then adding designs and selling them for a small profit to those who pick up packages. Income-earning opportunities for shop owners who participate as pick-up points, can grow by value and volume as foot traffic increases. As user traffic grows and word spreads, OkieLa is well positioned to drive efficiencies in e-commerce in a way that directly empowers and benefits the poor.

Source: Interview with OkieLa, June 2017.

development impact assessment that goes beyond one-dimensional indictors and checklists. Yet from the practitioner's perspective, beneficiary analysis is vital for three reasons:

(i) **Client segmentation.** The poor are not homogeneous, are often resistant to change, and are value- and quality-conscious. Understanding variables, such as income levels, cash-flow fluctuations, seasonality, demographic concentration and dispersion, tastes, and other cultural and societal norms, is just as important for businesses focused on the poor as any other socioeconomic group. Different socioeconomic groups or strata, even in the same location, may face very different challenges. To tailor a good or service to the poor or to incorporate them into a supply chain, the nature of the poverty penalty that they face must be understood, and the IB financier must take all differences into account.
(ii) **Product/service development.** To be successful, IB models must accommodate multiple poverty-related variables affecting one or more demographics. IB viability drivers must be fine-tuned to the challenges faced by the poor. Access and affordability are the most familiar, but others include timing and location (e.g., the accessibility

and availability of a training module for lower-income groups); convenience (e.g., how someone who is already working numerous jobs can participate in an IB offering with minimum disruption to the current routine); and logistics and distribution (e.g., solutions to the last-mile delivery issue). Hence, a deep appreciation for target customer segments, especially ones sensitive to cash flow, is essential.

(iii) **Business development.** Effective business development, strategic planning, and resource allocation must include knowing one's customers, producers, suppliers, and distributors, as well as understanding their particular needs and constraints. Product/service innovation, iteration, and piloting are expedited when companies have a clear idea of the who, what, when, and how.

Fund managers and financial institutions require in-depth knowledge of their investees and borrowers. Experienced fund investors and investors in, or wholesale financiers of, financial institutions scrutinize not just the suitability of the goods, services, financial products, or engagement strategies proposed but also the prospects for future growth. Growth can come from doing more of the same thing or from developing additional offerings. The success of either depends on how well current and potential clients are understood. The invitational contribution in Box 5, the first of several from industry experts, explores these issues in greater depth.

D. Inclusive Business Financing Modalities

1. Capital Deployment

IB financing is more than just a transaction—it is more than simply providing capital to an individual or business. It denotes a range of activities, performed by numerous stakeholders. To the extent that there is a unifying extrafinancial principle or motivation, IB financing is also the conviction that there is commercial value and financial return in providing capital to private businesses to address social and environmental challenges. It takes the following forms:

(i) **Discrete capital allocation.** This is the provision of financing, most often debt, equity, or quasi-equity, to an individual or MSME for the purposes outlined above. Such capital is usually, but not exclusively, provided by a financial institution; an investment fund; or directly by an individual, family office, or foundation.

(ii) **Program and product design.** Financial institutions design lending programs and financial products that seek to address a market opportunity deriving from one or more aspects of exclusion (e.g., micro and small enterprise starter loans for clients with no collateral or borrowing track record).

(iii) **Wholesale capital provision.** A financial institution provides debt or equity to expand current IB operations and products or to launch new ones. Depending on the capital provider, it can be accompanied by nonfinancial support, including business development services, management information systems, credit appraisal methodologies and training, and sector expertise. The providers of wholesale capital to financial institutions include MDBs, DFIs, commercial banks, and, in some cases, investment funds.

Box 5: Voices of Practitioners: Inclusive Business, Impact, and Benefits for Poor and Low-Income People

Joe Shamash is the evaluations manager for the Private Infrastructure Development Group, an organization that "mobilizes private sector investment to assist developing countries in providing infrastructure vital to boosting their economic growth and combating poverty.

Impact investment pursues positive social and environmental outcomes through and alongside financial returns. These are sometimes referred to as the triple bottom line, or the three Ps: People, Planet, and Profit. With reference to the first P, People, any assessment of the impact generated by a company should address the following questions:

1. Who is affected by the investee company?
2. How do they interact with the company?
3. What do they gain (or lose) through interaction with the company?
4. How many people are affected?

These questions illustrate that impact measurement for investors and businesses is predominantly about understanding markets. The same information is therefore critical for managing commercial performance and social performance.

1. Who is affected by the investee company?

Understanding the characteristics of people served or affected by an inclusive business is important for assessing the relevance of the business's value proposition. This information can also guide business operations, including sales and marketing, product design, and supply chain management. Key characteristics include:

- **Socioeconomic factors.** Whether the people who benefit from engaging with a company are poor, low-income, or underserved by any recognized definition is a critical consideration for any inclusive business. Factors such as household income, education, assets, and consumption levels may be particularly relevant.
- **Existing levels of access.** The types of goods, services, or income-generating opportunities that the inclusive business seeks to offer.
- **Gender.** The ways in which the experience of men and women differ as consumers, suppliers, producers, distributors and/or employees.
- **Other factors that influence access to markets.** Including location (whether rural or urban), ethnicity, age, and employment status.

All the people reached by a company are unlikely to fit into one grouping or classification. Segmentation of customers can help provide a clearer picture of a company's performance on social goals, and support targeted services. A company providing credit to customers to purchase solar home systems, for example, may use segmentation to identify the appropriate product and payment plan for lower-income and higher-income households, ensuring default rates are minimized.

2. How do they interact with the company?

An inclusive business may have a range of material effects on people through direct or indirect interactions. These interactions have direct beneficiaries and indirect beneficiaries.

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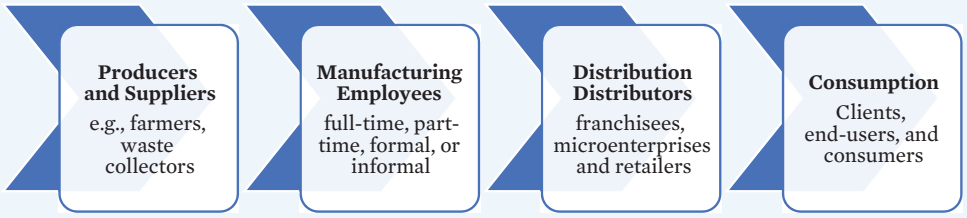
Box 5 *continued*

Direct beneficiaries. These fall into the categories across the value chain presented below.



Inclusive business models that focus on generating positive impacts in the supply chain are most commonly found in agriculture and manufacturing. Businesses that seek to generate positive impact through essential services such as energy, education, health, water, and sanitation are likely to focus on measurements related to end-users and clients. Although supply and employment effects for such companies might not be relevant to their main social goals (for example, a waste-processing and sanitation company aiming to improve water safety and hygiene in slums), they remain an important part of the equation for social performance.

Indirect beneficiaries. These include people benefitting through a wider range of channels, including

- knock-on effects from direct beneficiaries, for example, improved opportunities for local microenterprises that are able to sell to company employees or suppliers whose incomes have increased;
- tax contributions and support for local infrastructure;
- provision of inputs for essential goods and services, for example, a company providing affordable solar energy to a school that is then able to improve education services for students;
- local market competition, which may improve prices for consumers, destroy jobs in competing enterprises, or reduce general availability of resources required by the company (for example, an agro-processing facility that improves local farmer incomes may require large amounts of fuel and water, reducing availability for others); and
- systemic change brought about by a company, for instance, developing a new technology or business model that is adopted more widely.

It is much more difficult to measure impacts for indirect beneficiaries than for those engaging directly with a company. Market research during investment scoping and due diligence can be used to provide qualitative assessment of potential indirect effects and to identify suitable proxies for ongoing measurement. A school chain, for example, may compete with other local education providers for students (as customers) and teachers (as employees). The school chain has the potential to catalyze improvements by education providers who adopt new practices or technologies in response to the new market

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Box 5 *continued*

entrant. Negative effects are also possible, as a result depletion of the best teachers from other local schools, or attracting the students from households that are most engaged in education. An assessment of local education options should provide an indication of two factors: first, the potential opportunities for positive indirect effects and risks for negative effects, along with appropriate indicators (for example, local public school exam results); and second, the degree of market saturation, the scope for the school chain's growth in the local market, and the ways in which the company should seek to differentiate itself from existing offers.

Where the main impact of an investment is via "systems change" or another indirect route, measurement may focus on other market actors (e.g., tracking behavior change among competitors) rather than on end-beneficiaries.[a]

3. What do they gain (or lose) through interaction with the company?

Putting aside systemic effects, the direct impacts of inclusive businesses result from changes to the availability of essential goods and services, and changes to income-generating opportunities in local markets.

Examples of Benefits Generated by Pro-Poor Inclusive Businesses

	Sample Benefits	
Sector	Outputs	Outcomes / Value Proposition to Consumers
Health care	Antenatal and postnatal consultations delivered; patients treated; vaccines administered	Lower rates of infection; lower rates of maternal and infant mortality
Education	Students accessing affordable quality education	Improved educational attainment; higher rates of progression to further education and employment
Energy	Solar energy appliances provided	Savings on kerosene fuel or firewood (time/finance); improved domestic air quality; lower incidence of respiratory problems
Water and sanitation	Potable water treated	Improved access to safer and better-tasting water; lower rates and risk of infection
Food	Quality child nutritional supplements delivered	Lower rates of child malnutrition; reduced incidence of child stunting; improved taste and convenience resulting in greater consumption
Agriculture	Quality seeds and fertilizer delivered	Improved yields, savings and efficiency gains; higher incomes
Microfinance	Affordable credit and insurance provided	Savings on credit costs; microenterprise growth and/or improved profitability

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Box 5 *continued*

Measurement approaches that seek to calculate net effects that balance positive impacts against negative impacts are rare. This is partly due to negative indirect effects being largely out of the scope of operations or commercial interests of most businesses. Impact investors may consider the following options for addressing negative effects:

- environmental, social, and governance (ESG) assessment and compliance;
- accreditation programs, for example, Fairtrade Certification, organic certification, Gold Standard Carbon audit; and
- partnerships with independent research institutions, nongovernment organizations, or other grant-based initiatives to conduct wider research and impact evaluation.

4. How many people are affected?

Tracking the number of people that gain some benefit as a result of a company's activities provides an indication of the scale of impact. Businesses which have direct and ongoing relationships with their beneficiaries (e.g., clients who have subscribed for services) can use their company operations to provide reliable answers to this question. Businesses at the earlier stages of development frequently require additional support to establish operational processes for managing information. Impact investors who back early-stage enterprises with such business models may, therefore, need to consider technical support or connections to other initiatives in order to gather information.

Measuring the impact of companies that interact with end-beneficiaries infrequently or indirectly (e.g., a company that sells seeds to an intermediary that then onsells to smallholder farmers) is more complicated. In the absence of data collected through daily company operations, measurement of scale must rely either on formulae based on existing evidence available in the sector or market, or end-beneficiary surveys.[b]

[a] Inclusive businesses in developing and emerging economies often reference national or international poverty lines, such as the World Bank's $1.90 (2011 purchasing power parity [PPP]) international line for extreme poverty, and $3.10 (2011 PPP) for poverty. Businesses that sell products and services to end-beneficiaries are unlikely to reach large numbers of people living below extreme poverty lines as customers; however, business models that serve bottom-of-the-pyramid segments of the population who are low-income, e.g., below the national median in a developing country, are well documented.

[b] See D. Nippard, R. Hitchines, and D. Elliott. 2014. *Adopt-Adapt-Expand-Respond: A Framework for Managing and Measuring Systemic Change Processes.* Durham, UK: The Springfield Centre for Business in Development. https://beamexchange.org/uploads/filer_public/55/99/55991aa8-1a33-4dbd-bfac-ef3c7ba5b81c/adoptadaptexpandrespond.pdf

(iv) **Capital aggregation.** A mainstay of IB financing is capital aggregation, which is the creation of a pooled investment vehicle, usually a private equity or debt fund, that invests then exits from a number of IBs over a period of time. On the basis of a detailed investment strategy, pipeline of investment opportunities, and investment track record, capital is aggregated by a prospective fund management team for a particular investment theme, in this case, IB.

Funds have been the most common capital aggregation strategy in IB financing to date. However, because most funds are closed-end (i.e., generally have a defined life of 8–12 years), some practitioners are experimenting with other vehicles such as investment holding companies. The rationale is that closed-end funds necessarily require portfolio divestment by a certain time. For some investees (and indeed, investors in terms of returns), this may be suboptimal. Yet both modalities have merits, and certain investment types are best accommodated by open-ended or evergreen vehicles, such as start-ups and early-stage companies.

Capital is also aggregated into the fund-of-funds model. A fund of funds deploys capital into a portfolio of funds according to a theme, sector, or geography. Capital is provided by DFIs, institutional investors, MDBs, and, in some cases, commercial banks, among others, to be deployed by an industry expert across various relevant fund strategies. The rationale for the product is that the fund-of-funds manager will create an optimal portfolio of funds based on sectoral and geographic expertise that the asset owner does not have.

2. Idiosyncrasies of Inclusive Business Financing

Effective IB financing requires a combination of carefully selected financial instruments and, in many cases, nonfinancial support. IBs have much in common with MSME lending/investing in this regard. However, it is helpful to think of IB as a subset of generic MSME financing with particular needs, reflecting the challenges associated with the inclusion thesis embedded in the IB model and demographic and socioeconomic context in which the IB operates.[11] IB financing is most effective when the instruments used and nonfinancial value added address and accommodate these factors. In this way, both the lender and borrower, in cases of debt, and investor and investee, in cases of private equity, follow a common vector. The key, therefore, is for the lender/investor and borrower to share a clear understanding of what the IB requires to achieve sustainable growth. It is a familiar maxim that many MSMEs do not know what they do not know, do not necessarily know what their needs are (financial and nonfinancial), and do not necessarily need what they believe that they need. The key to effective IB financing is anticipating blind spots at every stage of the loan or investment cycle, especially in product design, borrower/investee engagement, capital deployment, and portfolio management.

Financial needs. All businesses need financing to grow. The key question is what kind of finance do they need: debt or equity. In the end, however, businesses may not have a choice after all. Equity may not be available due to company size, its current stage of development, risk profile, quality of financials, or degree of informality. It may also be that equity investors are not active in a particular geography or sector, or that it is prohibited by local legislation. In the case of debt, the loan size, terms, and tenor must suit both the IB and the borrower.

[11] Some key factors include the enabling and policy environments and the macro and political conditions.

The distinction made here between the business and individual liable for repayments is important. The loan size and repayment conditions must do two things: suit and support the productive capacity of the business and thus the cash flow it generates, and accommodate the relationship between these and the borrower's own needs (i.e., between the commercial and personal). This is especially significant in developing economies, where the smaller the business, the more unclear the lines are between the commercial and personal. There may be no perceived or actual distinction at all. Therefore, a lending institution cannot consider commercial and personal cash-flow sensitivities independently from the other.

Nonfinancial needs. Emerging market IB invariably needs nonfinancial support, regardless of size. Medium-sized enterprises seeking debt or equity of $2 million–$10 million may also require intense engagement, although not as intense as micro and small enterprises. The focus areas tend to be similar, and include some or all of the following: management capacity, corporate governance, strategic decision making, working capital and asset allocation, financial systems and controls, inventory management, and marketing.[12] Further, it is possible to identify areas of engagement required for particular IB models:

(i) **Consumer-focused.** Customer and market segmentation, data collection and management, client outreach and engagement, pricing, product marketing and positioning, and inventory management.
(ii) **Producer/supplier-focused.** Training and upskilling, access to financing, access to and training in application of key inputs (e.g., seeds and fertilizer for farmers), use of technology, logistics and distribution, packaging, certification, and compliance.
(iii) **Distributor-focused.** Product understanding and sales training, cash management, use of technology, and client outreach and capture.

Value addition in nonfinancial areas raises the question of who bears the cost. In the private equity model, the fund manager uses the management fee paid by investors to create value by engaging deeply with portfolio companies. Alignment of interests between investors and the fund manager incentivizes such engagement. In the case of many IB funds, a discrete pool of TA funding is also made available for this purpose.

Cost-bearing is not as clear with debt. Financial products generally need volume and economies of scale to break even and become profitable. Loan officers have neither the time, skills, nor resources to mentor the hundreds or even thousands of borrowers in their portfolios. Yet one could venture that these more precarious entrepreneurs, micro and small enterprises, have most to gain from such value addition. This issue is explored in detail in Section IV, but note here that the financing–advisory gap can be bridged by modifying traditional and proprietary financial inclusion techniques and introducing new technology. Indeed, some financial institutions are finding innovative ways to cover the costs of client engagement. To the extent that growing IBs deliver direct and externalized benefits to society, alternative or supplementary cost-bearing arrangements should be explored in support of accelerated IB growth.

[12] Note that not all of these areas apply to individual entrepreneurs and microenterprises. Corporate governance training is unlikely to benefit the street vendor or mom-and-pop shop owner, and a shoe polisher will probably not increase revenues by appointing a board of directors. This said, the marginal benefit to the street vendor of financial literacy training is just as great, if not greater, than bookkeeping training is to a small enterprise.

E. Conclusion

The needs of inclusive businesses are many and complex; even the identification of active or potential IB models can be challenging. Tailored lending and investment approaches are required to meet IB needs effectively, yet this is only possible if the practitioner is engaging from a solid institutional platform (i.e., bank or fund) that establishes a constructive balance between experimentation and risk taking on one hand and commercial rigor on the other. Especially in the fund context, relationships between purveyors of financing and recipients of financial products depend on the robustness and perspective on entrepreneurs or MSMEs of the establishments providing them. The perspective needed is of the entrepreneurs or MSMEs as an opportunity and change agent best served by flexible, context-specific solutions. In this way, the discipline of the relationship with the lender or investor cements the foundations for commercial success and profitability.

III

The Role of Financial Institutions in Inclusive Business Financing

A. The Evolution of Financial Institutions in Inclusive Business Financing

It is clear that finance is the lifeblood of micro, small, and medium-sized enterprise (MSME) growth, but access to finance remains problematic for many. It is also clear that the importance of agriculture as the primary endeavor of base of the pyramid (BOP) populations throughout Asia makes it a priority sector for inclusive business (IB) financiers. Naturally, much micro- and small-scale lending is focused on value capture and local value added in agriculture and beyond. The following case studies from South Asia and Southeast Asia show that, implicitly or not, the importance of agriculture is nudging financial institutions into supply chain and value chain finance, while breaking down conceptual barriers of financial inclusion as an individual- or firm-centric activity. In Asia, from a financial institution perspective, this supply and value chain focus is becoming a key financing opportunity of the future.

Little would be gained from another review of products that have advanced financial inclusion since the 1970s, yet the issue of how competition is fueling innovation and urging financial institutions to reconsider the financing needs of MSMEs warrants examination. Arguably, financial institutions are now at the forefront of three vital developments: recasting conceptions of how supply chains and value chains materialize and grow, understanding who is active within them, and creating inclusive financial products to nurture and expand these chains. Financial institutions have thus become central to reducing poverty and inequality, and those that respond to clients' entrepreneurial, socioeconomic, demographic, and cultural contexts are best at innovating products. This section explores the magnitude of financing the BOP opportunity in Asia, which, by any measure—purchasing power, unattended demand, or population size—demands financial institution engagement with lower market segments. The aim of the case studies presented in the next subsection is to show a sample of IB financing strategies that can be emulated throughout Asia and beyond.

1. Financial Institutions and the Small and Medium-Sized Enterprise Sector

MSMEs account for a large proportion of economic output and employment across developing Asia. According to the Country Risk Service of the Economist Intelligence Unit, in some of the poorest countries, like Cambodia, the Lao People's Democratic Republic, and Myanmar, the figure is higher than 85%. In some middle-income countries, such as Malaysia and Thailand, data on dispersion of economic activity are skewed by decades-old conglomerates. Yet often, there is little between quasi-oligopolies and the tens of thousands of MSMEs that employ the bulk of the populations.

The structure of the banking sector tends to be unbalanced in developing Asia. Typically, large domestic and international banks compete for limited corporate financing opportunities. Retail banking can appear dynamic by the sheer number of banks, but quantity and efficiency are different things. Bangladesh, for example, has over 40 retail banks, yet many are unprofitable, and the sector needs consolidation.

Yet the MSME sector—the socioeconomic fabric supporting many rural, peri-urban, and urban livelihoods in Asia—has long been the shunned by formal financing institutions. This is because MSME banks in many Asian countries often began as creatures of the state. Many remain so, especially in sectors that governments consider strategic or particularly sensitive (e.g., the agriculture sector in India). As such, they tend to be inefficient and subject to politically directed lending. In many instances, they are kept afloat by governments even when loss making, distorting markets through subsidized interest rates and write-offs of nonperforming loans.

Since the 2000s, there has been a rapprochement between banks and the MSME sector. Factors contributing to this reconciliation include the following:

(i) **Falling poverty rates.** The emergence of millions from poverty to near-poor, lower-middle-class, or middle-class status, accelerated by technology and social media, has increased pressure on governments to address burgeoning demand in the lower-income segment, of which one component is demand for financial services.

(ii) **Rising expectations.** The expectations harbored by previously disenfranchised groups toward the level and effectiveness of government spending and national development programs have risen dramatically. Social media has given these groups voice, greater access to information, better organizing capacity, and thus agency. More conducive financial sector policy initiatives—unshackling MSME banks in some countries and areas, and prudent facilitation of microfinance institution (MFI)/nonbank financial institution (NBFI) conversion to deposit-taking institutions or full bank status in others—reflect governments' recognition that rapid, sustained MSME growth is vital for poverty reduction and social stability; and that this requires an environment that enables vast increases in bank financing to MSMEs.

(iii) **Technological advances.** Technology, information sharing, digitalization, new credit bureaus, and real-time client monitoring are spreading, mitigating the risks of MSME lending.

(iv) **Unattended demand.** Even in countries less populous than India and the People's Republic of China (PRC), banks are realizing the magnitude of aggregate demand of lower-income groups for basic goods and services.[13] More specifically, pioneering MFIs and financial institutions are recognizing that to channel this demand, thereby capturing the opportunity themselves, they must be the conduit for growing purchasing power and the facilitator of the BOP's ability to engage in economic endeavor. In other words, they are the guardians of the lubricant (i.e., finance) that oils the wheels of economic endeavor (i.e., inclusion).

(v) **Withdrawal of the state.** In most of Asia, the state's role in the banking sector has gradually, if not entirely, diminished.

[13] It is a staggering data point that, despite the hundreds of millions of dollars of microfinance lending in India, for example, an estimated 85% of the market remains untouched (Based from the interviews with Ajay Desi, a former officer at the Yes Bank Ltd. in India, and Debraj Banerjee of Janalakshmi Financial Services).

2. Harnessing the Potential of Financial Institutions in Inclusive Business Financing

If it is agreed that the government, private sector, and financial sector share an interest in making more IB financing available to MSMEs, banks must be at the center of this process. Their physical and now digital reach is unparalleled, and their medium, debt, can be provided at scale in a way that equity cannot. When done methodically, financial institutions are well placed to innovate and to implement products that can be customized once proven. With rigorous risk management and monitoring systems, banks can realize economies of scale and service lower-income market segments profitably. Lastly, data management capacity and the ability to gather and base decisions on so-called big data mean that the evolving financial needs at the individual, commercial, sector, and geographical levels can inform product design. Taken together, these factors are facilitating wealth creation and savings mobilization. For financial institutions, this represents a significant opportunity to handle, redeploy, and grow these assets. For lower-income groups, it represents an important stepping stone out of poverty.

IB lending has its limitations, however. High-volume lending is, by definition, low-touch; product economics and bank cost structures do not allow for intensive lender–borrower relationships. Additionally, product offerings tend to be horizontally segmented across financial institutions by size rather than vertically segmented within them. Once borrowers reach maximum loan sizes, they must approach other institutions. Yet the credit histories of the poor do not travel well from bank to bank, and establishing relationships with new banks is time-consuming and expensive. Collateral requirements can be more onerous for larger loans, and the records required can exceed the means of the poor to produce them. It should be remembered that, for the poor, time can be as scarce a resource as money.

Many lessons can be applied to IB financing from the maturation of the microfinance sector since the 1980s. Across Africa, Asia, and Latin America, a pattern of escalating competition between MFIs and MSME banks has emerged, catalyzing not just product development and innovations in risk management but also optimization of cost structures to enable greater client engagement. As client retention demands more client face time, technology and efficiency gains help make this possible. Cambodia, India, Pakistan, and Sri Lanka are good examples of this. As the case studies below demonstrate, client onboarding, refined by MFIs, also has pertinent applications for IB financing.

There is, however, one stumbling block, which neither technology nor improved risk management can overcome. The business models of the entities best placed to ramp up IB financing—banks—do not lend themselves to intensive client engagement, no matter the efficiency gains or cost reductions achieved. Yet the most compelling opportunities for banks, and the most significant from a socioeconomic perspective (i.e., the IB sweet spot) are the individuals, or MSMEs that most need such engagement. This can be called the "dilemma of the unheld hand"—what to do when the putative hand-holder (i.e., the bank) cannot afford, and has neither the expertise nor the staff, to hold the hand of the borrower?

The dilemma may never be fully resolved—perhaps the issue can only ever be contained. The case studies demonstrate that hybrid products fusing microfinance techniques with small-scale lending are part of the answer; cost-recovery mechanisms, no matter how small, must be built into loan products at the earliest juncture; such mechanisms enhance lender–borrower alignment and inculcate borrower appreciation for the value of the

relationship beyond the loan; and positive results from numerous hybrid approaches are encouraging increased financial institution engagement in the segment. South Asia is leading the way, especially India, with its aptitude for technology and the affordability of digitalization.[14]

3. Identifying the Financing Requirements of Inclusive Businesses

Naming the financing requirements of IBs is simple: cash, credit, or working capital. However, these categories are much more nuanced than they appear. There can be disparities between how IBs perceive their needs and what they actually need, or what is in their best interests. Similarly, financial institutions may underestimate the complexity of IBs' needs. Thus, successful IB financing strategies involve an ongoing dialogue between lender and borrower, through which each communicates to the other its needs, expectations, constraints, and pain points. The intensity of the dialogue tends to be greater in more competitive markets such as India. Still, financial institutions must remain flexible to retain customers, innovating constantly because clients' needs will develop over time.

Outlined below are some key focus areas, mechanisms, and instruments that are needed, in addition to or alongside cash and credit, to accelerate IB expansion:

(i) **Agriculture-focused products.** The contribution of agriculture to economic output in Asia is so large that financial institutions involved in the MSME sector struggle to ignore it. As such, it comprises a disproportionate number of low-income borrowers, presenting challenges like low-value transactions, limited or no financial literacy, volatile cash flows, product seasonality, weather- and disease-related risk, collateral constraints, and limited client growth prospects related to small farm sizes and land title restrictions. Developing profitable business models that balance affordability with risk management is not easy, the more so because farmers are sensitive to every major variable, such as interest rates, loan-processing times, transaction costs, collateral requirements, and need for financial record keeping. Further, financial institutions must find a way to process a high number of loans while minimizing transaction costs and nonperforming loans, which can only be achieved through efficiency gains and increased productivity of loan officers. This requires investment in training, systems, and technology, and, ideally, limited staff turnover. Lastly, regulatory frameworks have become more onerous in the wake of the Asian financial crisis and global financial crisis. Provisioning requirements tend to be high, and the available fixed asset collateral must often be depreciated, so meeting central bank limits can be crippling. Forward-looking financial institutions are realizing that they need to structure solutions to the following obstacles:

   (a) **Compounded risk.** Risk in agricultural lending is never one-dimensional. It derives from price, market access, market information availability, input availability, affordability, quality, and uncontrollable factors like weather events. Pooled products and area-based indexes and modeling are important, because weather events, unlike a factory fire, for example, affect entire regions and all borrowers within. Information sharing and technology transfer among financial institutions are crucial, as loss absorption capacity and internal hedging through small and affordable premiums to build reserves are important to financial institution resilience.

[14] Commonly referred to as digitization in India.

(b) **Collateral constraints.** Farmers struggle to meet collateral requirements. There has been much innovation, especially in the area of cash flow-based lending and development of proxies for traditional collateral, but more flexibility is needed from financial institutions. Financial mechanisms must be ramped up that take harvested crops or future harvests as their point of departure for credit appraisal. Such mechanisms include factoring, reverse factoring, leasing, warehousing, and other commodity-based approaches.

(c) **Size limitations.** Most agriculture in Asia is done by smallholders, denoting limited plot sizes and income per household. On limited land, yields can rise, but only up to a point. Therefore, it suits financial institutions to promote the formation of producer associations as a way to relieve financing bottlenecks. Additionally, an association's ability to create a corpus or vulnerability fund can unlock further funds and higher loans. Financial institutions must engage with existing cooperatives, associations, or groups of farmers.

(d) **Contract farming.** Contractual relationships imply a degree of negotiation, and thus, deliberateness and planning are involved, rather than serendipity. They can develop forward-financing mechanisms to ease suppliers' cash-flow constraints in pursuit of their product. As there can be wide cultural gaps between farmers and formal companies of any size, financial institutions are strategically positioned to broker and foster such relationships, thereby relieving both parties of financing constraints.

(ii) **Supplier/trader credit.** Such products include cash advances to be repaid after harvest or collection of nonagricultural outputs, input supplier advances that are repaid or subtracted from the purchase price, or guaranteed sales agreements that can be used by farmers to access financing. Innovation is required to link these products with insurance mechanisms so that relationships are not terminated by one-off events.

(iii) **Leasing.** Regulatory arrangements permitting, leasing is a critical mechanism for providing access to unaffordable equipment and machinery. It is particularly effective when the lessor is leasing to a cooperative or producer association, because its collective assets are more likely to satisfy the lessor's requirements, and it is more likely to be able to make repayments in the aggregate. The contribution of leasing to wealth creation and poverty reduction cannot be overstated, because it enables increases in output that would otherwise be unrealistic.

(iv) **Credit enhancements.** Guarantees and first-loss mechanisms encourage banks to take greater risk. Caution is required to avoid moral hazard, financial institution reliance on credit enhancements, and complacency. One effective complacency inhibitor is the use of step-downs, whereby the percentage guaranteed or proportion of loss covered diminishes over time. This forces the financial institution to wrestle with the long-term viability of the product and to assume greater risk over time.

(v) **Insurance.** Insurance for crop failure, weather events, or flooding has developed across Asia since the late 1990s. Microhealth insurance is also a growing product area, which can reduce household vulnerability. Inherent challenges, however, exist, such as adverse selection, causal verification, independent loss assessment, and administrative costs. In remote regions or sparsely populated countries like Kazakhstan and Mongolia, lack of critical mass undermines the risk-pooling arithmetic. However, there is much innovation around risk modeling, technology-enabled remote monitoring, and weather advisory strategies, making it feasible to insure more individuals and MSMEs.

The prominence of agriculture in Asia and thus, the importance of appropriate IB financing mechanisms for agricultural value chains is explored in Box 6.

Box 6: Voices of Practitioners—Financing Inclusive Businesses in the Agricultural Value Chain

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While the financing community may instinctively apply the same consideration to financing inclusive business (IB) as it would to any other entity, such an approach may limit opportunities for growth of IB as well as result in foregoing attractive investments for financiers. Traditional expectations about asset-based lending, working capital financing, and J-curve trajectories need to be reconsidered in light of the idiosyncratic nature of these entities. This is particularly the case with agriculture-based IB that sources from smallholder farmers.

Asset-based lending. It is often prudent for IBs to establish their businesses with limited capital investment both to reduce risks and to address logistical barriers that result from centralized processing or warehousing functions. For example, in agricultural value chain enterprises, participation by local farmers can be optimized by allowing them to bring their produce to neighboring collection centers that can be reached on foot, as opposed to expecting deliveries to centralized warehouse facilities that often require motorized vehicles that may be unaffordable to smallholder farmers. These nearby collection centers can often be rented facilities converted from small vacant structures. As such, IBs often establish their operations without major investments in fixed assets, reducing the risks of burdensome fixed costs and upfront capital requirements, but also resulting in balance sheets for which asset-based financing and securitized collateral are challenging.

Working-capital financing. IBs often need to provide their suppliers with working capital financing to ensure adequate resources for the acquisition of inputs necessary to meet quality and consistency standards. Such programs are particularly important in agricultural value chains, where the type of seed, fertilizer, and other inputs are critical to the quality of the crop yield. Impoverished farmers naturally gravitate to lowest-cost inputs given their lack of disposable cash. To correct this practice, IBs must often provide either the cash to purchase or directly provide the right inputs to their suppliers up front. In such cases, IBs often require cash for funding the working capital needs of their suppliers. Such financing cannot be backed by purchase orders, raw material, or work-in-process inventory. There are many opportunities for risk mitigation, including input credit programs and offtaker repayment plans. On providing inputs to suppliers, IBs can require them to agree that the inputs are being provided as loans whereby repayments are made by netting the amount due (plus interest) against the ultimate purchase of produce. This type of program works most successfully with short-term crops where growing cycles are a few months and cash turnover is quick. Such programs also require that lender financing to IBs be at rates that allow for affordable reciprocal lending rates to their suppliers, and perhaps low enough to provide a margin to lend inputs at a higher interest rate to offset IB administrative costs. For offtaker repayments, IBs sell to one or more large buyers (i.e., offtakers), and financiers negotiate for repayment of their loans to the IB directly from the offtaker. For example, an IB aggregates crops from many small suppliers, sells these crops to a buyer who pays the IB

continued on next page

Box 6 *continued*

the amount due to the financier, and deposits the balance into the account of the financier, thus mitigating repayment risk to the lender.

Cash flow-based financing. Equity transactions can provide challenges relative to cash-flow predictability. IBs in the developing world's agricultural sector often need time to train farmers, disseminate inputs, achieve consistent quality, and optimize logistics. Added to those challenges are the risks of drought, flood, and infrastructure constraints, resulting in unreliable water and power distribution. Such risks are further exacerbated by inconsistencies in market prices and volumes, particularly in commodity crops. As with debt, there are opportunities for mitigation of cash-flow risk. These include multicrop strategies, optimization of gross margins, fixed-price procurement arrangements, partnerships with philanthropic investors, and technical assistance funding, often provided in so-called "sidecars." These are considered below:

- **Multicrop strategies.** IBs that are dependent on single crops, while focused in one area, bear higher cash-flow risk from crop failure due to disease, weather conditions, or market behavior. Multicrop organizations, particularly where crops have complementary growing conditions and harvest cycles, provide protection against some of these risks.
- **Gross margins.** As a result of these risk factors, stability in gross margins is important. While the projected steady-state operating expenses may be attractively low for such IBs, cash-flow stability is most assured when gross margins are healthy and consistent among crops. Financiers need to understand the detail behind gross-margin projections to assess the risk.
- **Fixed-price procurement arrangements.** Traditionally, smallholders and local buyers fluctuate their transaction prices daily, subject to local market benchmarks. Such irregularity places margins and cash flows at tremendous risk. Securing fixed or ceiling and floor prices from offtakers, along with volume commitments, allow IBs to make procurement commitments to small suppliers who prefer household income stability over uncertainty although market prices may exceed their locked-in price. Equity investors can be more confident in cash-flow projections with such arrangements.
- **Philanthropic partners.** Investing in IBs that have secured commitments from philanthropic investors to provide grants for farmer training and technical assistance reduces IB expenses to fund their own agricultural capacity-building programs and reduces overall risk associated with poor farmer practices. Financiers can also seek philanthropic partners to provide concessionary financing or first-loss capital, mitigating cash-flow risk to the commercial equity investor.
- **Technical assistance sidecars.** Equity investors can also consider providing sidecar funding for technical assistance for the IB. If provided in the form of debt, such financing can begin to yield returns in advance of longer-term equity investments in the core business of the IB.

Leveraging other financial opportunities. Commercial institutions should not underestimate the financial opportunities of bringing low-income farmers into reliable, sustainable supply and value chains. Many of these households have been unbanked and without access to financial services. By providing stable incomes, formality in transactions, and financial literacy training, these formerly underserved communities can become prospective customers for financial institutions, with opportunities ranging from savings accounts to household lending.

4. Value Chain Development as a Driver of Inclusive Business Financing Opportunities

The case studies in Section III expose striking perspectives on value chains. They show that IB financing is often not placed in the context of existing or potential value chains, and that concepts of value chains themselves are rather unimaginative. They are viewed as trajectories, or conveyor belts, on which goods travel through various stages of modification until finished and delivered. Regarding the value adder, a graduation in the size of company handling the goods is anticipated, perhaps from micro but more likely small to medium, and possibly large. Conversely, individuals are usually overlooked, except when typecast; for example, the trope of smallholders growing coffee or cocoa through a contract farming arrangement. As the case studies will show, however, the intermingling of microfinance and IB financing techniques, technology, and a deeper appreciation of demographic factors broaden perceptions of what a value chain is or can be and who is active within it.

Value chain financing refers to the provision of financing, financial services, or support services (e.g., capacity building) to and among any actors in the chain. It responds to the requirements, constraints, or challenges encountered by value chain incumbents or entrants. Interests are aligned between the financier and recipient as both benefit when the value chain is more efficient and resilient and when risks along it are minimized. This happens by forging strong relationships and tailoring products. Led largely by agriculture—specifically, the production and distribution of food—but also apparent in health care, education, consumer goods, and renewable energy, the emergence of value chains by new means and in new forms is challenging financial institutions to respond. As they do, the opportunity to co-foment chains is causing financial institutions to catalyze and to develop responsive products.

B. Case Studies in Inclusive Business Financing

The case studies in this section are intended to provide practical examples of successes and challenges in IB product design and implementation. Each case study examines a particular aspect of IB financing and is presented from the perspective of the financial institution, not the IB. As emphasized in Section I, this is an internal examination, to use a medical analogy. The report seeks to understand how the internal organs of financial institutions—systems, human resources, management, risk management, and budgeting—evolve as IB products are created, and how they are modified by them. In this regard, all case studies have two features in common: (i) the iterative journey of product creation, client capture, and retention awakens the financial institution to its potential as a demand-generator then a servicer of IB financing; and (ii) the financial institution becomes cognizant that—whether servicing individuals, or MSMEs; in rural or urban settings; formal, semiformal, or informal—it is in the business of value chain creation and expansion. The recognition of this fact becomes vital to maximizing the contribution that its financing can make to IB.

1. Traditional Financial Inclusion as a Springboard to Inclusive Business Financing: Yes Bank[15]

The first case study illustrates three aspects of the evolving IB financing landscape: (i) the importance of policy and regulatory reform as an impetus for innovation; (ii) the potential for modifying and applying certain microfinance techniques to IB financing; and (iii) compelling outcomes that result from fusing these techniques, especially client onboarding, with other MSME lending practices, such as supplier financing. Yes Bank also provides lessons on the interplay between governance (specifically strategic planning), management, (i.e., implementation), and product development.

Founded in 2004 by two financing professionals, Rana Kapoor and Ashok Kapur, Yes Bank is India's fourth-largest private financial institution, managing total assets of $14 billion in 2016. The evolution of its focus on sustainability and financial inclusion was analyzed in a Harvard Business School case study published in 2010.[16] The Harvard study traced Yes Bank's commitment to developing synergies and business solutions for sustainable growth from the perspective of corporate culture, product development, and financial returns. It also placed these in the context of India's shifting economic policy priorities in the 2000s and regulatory reforms introduced by the Reserve Bank of India (RBI). The question posed at the end of the Harvard study was how the board of directors could evaluate subsequent capital allocation priorities to "development banking" against ambitions to expand Yes Bank's retail and commercial banking operations. The underlying assumption at the time was that "development banking" would necessarily be less profitable, thereby implying significant opportunity cost to the bank.

This case study looks at how Yes Bank's experience with traditional financial inclusion strategies, like microfinance, has influenced its evolution toward IB financing products. Any new products developed by Yes Bank in the 2010s naturally benefited from its deep institutional memory and tested credit-appraisal and client-outreach methodologies. Yes Bank's traditional financial inclusion approaches and their application to IB financing opportunities are also responding to a critical market gap in ways that create a competitive advantage.

Background. Some aspects of India's banking, social, and economic policy landscape in the early 2000s must be highlighted to put this case study in context.[17] At the time, India's banking sector was primarily focused on urban, not rural, areas, reflecting decades of heavy regulation, a lack of rural branch networks, and state domination of agricultural financing. To the extent that private commercial banks could participate in agricultural financing, results were usually poor, as they were among public banks. This further entrenched financial institutions' aversion to MSME lending, let alone banking the microentrepreneurial, smallholder, and subsistence sectors. Meanwhile, social pressures mounted as a large middle class emerged amid the hundreds of millions who remained in severe poverty.

[15] All information in this subsection is taken from an author interview with Ajay Desai in May 2017. Desai was the former Senior President and Chief Financial Inclusion Officer of Yes Bank Ltd.

[16] M. Chu and N. Arora. 2010. Yes Bank: Mainstreaming Development into Indian Banking. *Harvard Business School Case Studies.* No. 9-311-063. Cambridge, MA: Harvard University.

[17] For a full discussion on the establishment of Yes Bank and the state of India's banking sector in the early 2000s, and macroeconomic policy environment at the time, see footnote 16: pp. 1–3.

In 2006, the RBI introduced a financial inclusion policy, urging banks to make affordable financial products available to lower-income groups. Know-your-client compliance regulations were thus introduced but with a fatal flaw: prospective borrowers with no financial track record could obtain loans if referred by a know-your-client-confirmed client. By 2010, rampant growth in lightly regulated microlending had led to overindebtedness—scores of borrowers had taken multiple loans—culminating in numerous borrower suicides, notably in the state of Andhra Pradesh. The RBI quickly stepped in, and microfinance activity all but ceased in 2010–2011 before stringent regulations were promulgated.

Another policy development during this time was the RBI revision of priority sector lending requirements for banks.[18] The regulations now explicitly included the rural and urban poor, and, in rural areas, a lenient, distortive interest rate and default regime were put in place. Both public and private financial institutions failed to meet these prescribed lending targets for priority sectors, with agricultural lending faring particularly poorly.

Naturally, these developments affected Yes Bank as much as its peers. Its response, however, was notably different. In hindsight, it is clear that Yes Bank's new financial products in the 2010s reflected Rana Kapoor's conviction that the market lacked complete banking solutions for emerging Indian companies. The products also demonstrated Yes Bank's intuition that individual and group lending for business activities require innovation to maximize the banking sector's contribution to economic growth, and the private sector's development for the effective penetration of the rural sector. Critically, the decision to develop a rural retail banking business, although reflective of Yes Bank's values, was reached only after extensive analysis of the unserviced demand and return projections on proposed products.

From traditional financial inclusion to rural inclusive business financing. In 2006, Yes Bank ventured into IB financing through a collaborative effort with a global NGO, Accion. The endeavor began with the launch of Yes Bank's urban banking product program, YES Sampann, targeting slum dwellers with no access to financing or credit history. The idea was to channel microloans to start-ups through Yes Bank branches, with Accion providing TA for business plan preparation. From a resource and cost-management perspective, the new YES Sampann product leveraged the bank's direct lending business.

After ₹150 million ($2.3 million) was disbursed in Mumbai and Pune between 2006 and 2009, the partnership with Accion and YES Sampann was discontinued due to regulatory restrictions. Although it had not achieved its goals, however, YES Sampann taught Yes Bank that a mere triangulation methodology—combining quantitative and qualitative data to assess borrower viability—was not the most effective client onboarding methodology in the Indian context, considering that typical urban clients (e.g., kiosk owners, street vendors, and shoe polishers) had irregular incomes and often no fixed addresses. It was clear that a more context-specific and robust client onboarding methodology was required in urban areas to extend such risky unsecured loans to this vulnerable target segment.

[18] The regulations were first introduced in 1968 as a way to increase commercial bank lending to sectors considered critical by government, notably agriculture and MSMEs. After several revisions in the 1970s, by the mid-1980s, the RBI was encouraging commercial banks to direct up to 40% of lending to an ever-increasing list of priority sectors. The regulations were again revised in the mid-2000s but failed to anticipate the impending microfinance crisis.

With the benefit of its individual lending experience and new financial inclusion directives issued by the RBI in 2010, Yes Bank then focused its attention on rural retail opportunities. With a significant, established presence in peri-urban and urban areas Yes Bank considered two facts. First, despite vertiginous growth in microfinance and small-scale banking across India, it was estimated that only 15% of a more than a 1 billion-strong market had been penetrated (i.e., 25 million–30 million borrowers out of 200 million viable borrowers). Second, there was still relatively little competition in rural areas, where public and private sector bank lending had been unsuccessful. There was undoubtedly latent potential and greater opportunity to serve the rural hinterlands and BOP members of society there. To do so, Yes Bank began to embrace a different methodology—the business correspondent rural banking practice (BCRBP).

The business correspondent rural banking practice. The BCRBP built on a more traditional financial inclusion initiative launched by Yes Bank in 2011, the YES Livelihood Enhancement Action Program (YES LEAP, Box 7), which leveraged business correspondents to source and to service self-help groups in peri-urban and rural areas. India has a long history of self-help group formation by NGOs and other NBFIs. Further, Yes Bank took its cue from the business correspondent guidelines published by the RBI. Yes Bank sought to generate multiplier effects through deeper collaboration with credible organizations that had extensive rural footprints; with business correspondents working for Yes Bank, Yes Bank could scale up its product and service offerings for the poorest of the poor. It could leverage these business correspondents to open asset and liability accounts for newly formed self-help groups while at the same time, individual borrower indebtedness could be monitored by countrywide credit bureaus, established post-microfinance crisis. This more robust creditworthiness appraisal regime meant that Yes Bank could have greater confidence in its business correspondents. Risk management was further enhanced by incentivizing business correspondents with borrower repayment performance.

Box 7: Yes Bank's Business Correspondent-Sourced Self-Help Groups, 2011–2012

Under the guiding principle of Frugal Innovations for Financial Inclusion (FI4FI), Yes Bank launched various initiatives to extend financial services to the last mile.

One was the flagship project YES Livelihood Enhancement Action Program (YES LEAP), in which Yes Bank business correspondents sourced women-only self-help groups for sociocultural reasons and provided attractive financial inclusion solutions to them through the business correspondent model. Most business correspondents were sourced from nongovernment organizations with 10–15 years of experience working with self-help groups.

Yes Bank's financial objective was to be cost-neutral. It adopted practices that in effect transformed it into a bank within a bank: Yes Bank borrowed funds at 12%; the business correspondent added 3% to cover costs; and interest rates on loans from self-help groups to individual borrowers started at 36%, dropping to 25% over time. The spread between the self-help group and individual loans enabled the growth of the corpus, subsequently used to secure further borrowing.

Source: Author interview with Ajay Desai, May 2017.

By 2013, it was evident that although the BCRBP was successful, it could not scale beyond a certain point, owing to what one Yes Bank executive called "mind-set issues." These issues lay not with the borrowers, but with the NGOs. Yes Bank developed the view that the ambitions of NGOs were often limited to cost recovery and incremental returns; with no commercial motivation, NGOs were not inclined, for instance, to reach 10,000 households and to continue to grow thereafter. In addition, they were overstretched and found little reason to expand operations.

This led Yes Bank to foster partnerships with entities that had a profit motive. Business correspondents, for example, had the dual function of serving Yes Bank's target segment and scaling up business and outreach. Further impetus was provided by the RBI when it allowed NBFI-MFIs to become business correspondents. As Yes Bank sought to innovate further, it ventured into the joint liability group (JLG) model, which is considered to be the most efficient credit delivery model in small-scale lending.

Detailed knowledge of individual borrowers gained through self-help groups also enabled Yes Bank to identify the more enterprising and commercially promising group members. Whereas self-help group loans were, in essence, cash-flow smoothing facilities with 1- to 3-year tenors, newly formed JLGs could focus on entrepreneurial activity: home-based trading, agriculture, door-to-door sales, and delivery vehicle or rickshaw purchases. Also, as JLG loans were individual loans provided in smaller groups, they engendered a sense of responsibility in the borrowers compared to self-help group loans. Although still peer-guaranteed and pressure-based, the focus of JLG-member credit appraisals shifted from "spouse-related risk"—the key variable in determining a self-help group member's bankability was cash-flow volatility associated with a husband's behavior—to the viability of a commercial endeavor.

With sector-specific credit bureaus providing visibility on borrower history, Yes Bank could scrutinize aspiring JLG borrowers' commercial and financial aspirations. Loan sizes ranged from ₹15,000 to ₹50,000 ($230–$770). Some JLGs had as few as two women, but the validation of one member's start-up or expansion proposal by all other members was a vital component of Yes Bank's credit assessment. By March 2017, Yes Bank reached over 2 million households across 18 states and 260 districts in India through this program, and it has involved more than 40 business correspondents who have disbursed unsecured loans amounting to $750 million.

As most self-help group and JLG members are completing two to four loan cycles, the next step is for them to graduate to individual, larger loans. Yes Bank is now piloting another loan category, the individual loan, ranging from ₹50,000 to ₹200,000 ($770 to $3,075). The appraisal process for individual loans entails careful evaluation of borrowers' cash flows. Indeed, it can be said that this is the point of departure from semiformal lending to the beginnings of a formal banking relationship.

Janalakshmi data suggest that as few as 1%–2% of borrowers are likely to graduate beyond individual loans of ₹200,000 to ₹500,000 ($3,075–$7,700). When graduation does occur, a key factor is that it is both impelled and entrenched by inclusion. For example, cattle owners seeking to borrow ₹200,000 are not selling milk to neighbors or other villagers but to local procurement centers. Beyond five cows, the economics for the milk supplier change considerably, as investment, rather than working capital, is now required. Production is no longer artisanal; a steady, formal demand must be answered. Yes Bank's supply chain financing products are cognizant of these dynamics, and seek to deepen inclusion further.

Launch of supply chain finance products. With all banks now under pressure from the RBI to increase lending to priority sectors, some have opted to buy priority sector lending certificates. These certificates enable banks to fulfil their priority sector lending requirements without risking proprietary capital. Instead of exercising this option, however, Yes Bank's board of directors approved the formation of a supply chain finance team to focus on rural retail assets. Yes Bank's supply chain finance loans range from ₹200,000 to ₹2 million ($3,075–$30,770), and are intended for more affluent village dwellers.

It is important, however, to recognize this product's origins. In 2017, Yes Bank was approached by a rural dairy that was struggling to secure consistent, quality supply of raw milk. Despite the fact that the dairy had built strong relationships with farmers, for whom the company represents a steady source of demand for product, not all farmers could afford to purchase the key inputs—cows and buffaloes—to generate the product. The dairy thus approached Yes Bank for a solution. Yes Bank devised a variation of trader credit (also known as trader finance), whereby it leverages the company's relationships with individual farmers as part of the credit appraisal process. Loans to approved farmers are accompanied by sector training delivered by the company.

The key point is not that this is a new model; supplier financing has been used for decades in many developing countries, and some of India's largest banks are active in the area, notably the Housing Development Finance Corporation. However, the Yes Bank product is informed by, and builds on, its JLG and individual loan products. The borrower relationships cemented through the JLGs and individual loans enable Yes Bank to provide a continuum of bottom-up (e.g., self-help group, JLG, or individual loan) and top-down (e.g., supplier finance) offerings whose inclusion multipliers go far beyond the provision of financing. The following outcomes are notable in this regard:

(i) **Supply-chain linkages.** The top-down supply chain product resolves disjunctions in the chain by enabling farmers to finance the cost of goods sold.
(ii) **Bottom-up onboarding.** The self-help group–JLG–individual loan trajectory increases the universe of financially literate producers/suppliers with prospects for inclusion, over time, into semiformal and formal supply chains.
(iii) **Client retention.** Relationships in the informal and semiformal economies are not only significant, they have value that can be monetized. The poor prize stability highly, hence the ability to establish an enduring relationship with a financial institution that is responsive to borrowers' evolving needs fosters client loyalty.
(iv) **Internal efficiencies and cross-fertilization.** The product innovation process, institutional memory, and product proximity enables Yes Bank to leverage past experiences and lessons into product modifications and new product design.

From financial inclusion to inclusive business financing. Yes Bank's suite of products illustrates that financial inclusion is a viable gateway to IB financing for clients and financial institutions alike, and that techniques and best practices gained through iterations of financial inclusion products must be incorporated into IB financing strategies. In this sense, financial inclusion and IB financing are best conceived not as distinct categories but as cohabiters in a symbiotic relationship. The onboarding challenges overcome at the lowest echelons of financial inclusion find analogues in the incorporation of individual borrowers into formal supply chains. Moreover, the clients at all product levels are not segregated in their daily lives but are bound in a complex nexus of socioeconomic linkages.

There is merit in reconsidering the final question posed in the 2010 Harvard study on Yes Bank—development banking versus commercial banking. In the intervening years, the central issue confronting the board of directors seems to have been more of identifying the locus and drivers of economic growth and demand for financial services than about evaluating the relative profitability of commercial versus development banking. Indeed, Yes Bank's product suite implies that the distinction between the two is fading as the opportunity to service the unattended 85% of a 1 billion-strong population is better understood.

2. The Inclusive Business–Value Chain Nexus: Janalakshmi Financial Services[19]

Yes Bank's evolution into supply chain finance sketches the contours of one important route to IB finance, from a single-vector relationship between lender and borrower, to a single-vector relationship between lender and group, to a multidimensional relationship between lender and supplier, often with an offtaker in the mix. A subtle but significant shift in the financial institution's perception of the borrower is highlighted; as the borrower progresses along the product path, the financial institution's view of the borrower develops from an individual who may be creditworthy to one who is a driver and incumbent of an inclusion cluster. Critically, therefore, the inclusion cluster fulfills two functions: incubating the lowest echelons of a value chain, or inviting "pollination" by offering a supply of raw materials.

This begs a controversial question. Could it be that MFIs and DFIs have, themsleves, contributed to the low graduation rates of microborrowers into MSME proprietors by conceiving their financial/economic trajectories outside of their entrepreneurial contexts? Just as the improbability of the journey of a kiosk owner to a restaurant franchisee must be acknowledged, one must examine if the borrower as the embryonic value chain catalyst and incumbent is more realistic and value-accretive than the borrower as a potential, stand-alone entrepreneur. The next case study of a nationwide MFI based in Bangalore—India's technology hub—provides compelling evidence that the focus should be broadened in this way.

Background. Janalakshmi Financial Services was founded in Bangalore, India in 1999 as a nonprofit lending institution servicing the urban and peri-urban poor. Drawing on the self-help group lending model and prioritizing female borrowers, Janalakshmi issued its first group loan in 2000. Since then, it has expanded operations to over 200 cities across 19 states, and has nearly 13,000 staff members running more than 400 Jana Centres. Janalakshmi's balance sheet is approaching $2 billion, and it is a major presence in India's financial inclusion landscape. Janalakshmi's evolution from a traditional facilitator of financial inclusion into a full-service financial institution servicing the poor—providing savings, credit, microhealth insurance, microlife insurance, pensions, and MSME financing—is instructive because it forces IB financiers to challenge traditional conceptions of IB.

Each urban universe of informal, semiformal, and formalizing enterprises serviced by Janalakshmi constitutes an IB colony in its own right. Each has its own organizing logic and, like its formal commercial analogues (i.e., registered businesses), each resides, or forges new capillaries, within supply and value chains. Every colony is, in this sense, greater than the sum of its parts. This is significant because it calls into question the zero-to-scale journey

[19] All information in this subsection is taken from an author interview with Debraj Banerjee (Senior Executive at Janalakshmi), May 2017.

promised by microfinance, or the trope of the struggling petty trader to flourishing small business owner.

Densification. India has one of the fastest rates of urbanization in Asia and the world. Urban and peri-urban areas are densely populated, and, despite high turnover in arrivals and departures, they tend to retain a consistent core of inhabitants, many with strong relationships or, at the very least, acute awareness of each other's presence and economic activities. Janalakshmi's model accommodates these idiosyncrasies through Jana Centres. Divided into sectors, each Jana Centre covers no more than a 2-kilometer catchment area, in which it services up to 20,000 clients (ironically replicating the strategy of predatory local money lenders). There may be as many as 50 Janalakshmi clients on a single street or alleyway. Further, a Jana Centre will only lend to clients living within its radius, so both place of dwelling and economic activity are limited to the hyperlocal.[20] The concentrated geographical focus, known internally as densification, enables Jana Centres to become creatures of their communities by penetrating the complex web of socioeconomic interrelationships on the ground. From the perspective of the business model, densification generates economies of scale.

Janalakshmi onboards borrowers in groups, which can comprise 5–20 women, although the "sweet spot" from a risk mitigation and group cohesion perspective is 7–15 women. Financial literacy is generally nonexistent or limited, so client onboarding is high-touch and costly. Interestingly, the monetary value placed on the service at the outset, ₹700 ($10.85) for the group loan, is accepted by women as the price of formalization, and the financial education accompanying the loan becomes a driver of client loyalty and retention. Viewed as a journey toward economic empowerment and greater prosperity through financial literacy, the Jana Centre experience also sensitively accommodates cultural norms.[21] An atmosphere of partnership and equality is created by ensuring that women are, for example, seated on chairs for pre-loan training. If they were sitting on the floor, the cultural connotation would be patriarchal hierarchy.

Borrowing by women from this demographic reflects two motivations: economic independence and expansion of their economic activities. Few women in these areas can count on their husbands to generate steady earnings, let alone manage cash responsibly. The impact of cash-flow volatility on such precarious livelihoods is enormous. Thus, the typical female borrower—the petty trader, street vendor, or small shop owner—looks to increase her daily revenue, generate more cash, and steady household finances. The woman seeking a larger loan is, perhaps, selling wholesale to larger MSMEs, and is looking to consolidate her position in the supply chain. The progression from the small borrower to a large loan borrower can be seen as an evolution from cash-flow smoothing to working capital, with a corresponding distinction by the borrower between personal finance and business activity.

Janalakshmi's lending operations are handled by two divisions (retail financial services, and enterprise financial services), which were created in accordance with the 2010 RBI regulations on converting an NGO to an Non-Bank Financing Company-MFI. Although a seamless series of products from the borrower's perspective, these divisions reflect the distinction between

[20] When the number of borrowers exceeds the capacity of a Jana Centre, the center is subdivided into two branches, each covering a redistricted geography.

[21] It is important to note that for a poor woman in urban India, entering any bank branch can be intimidating its own right.

women's informal, personal-cum-entrepreneurial financial needs serviced in the group context, and the early-to-mid-formalization needs of micro and small enterprises.

The entry product is the small batch loan, divided into first loans and second loans, totaling ₹15,000–₹50,000 ($230–$770). Most women borrowers have no credit history and are financially illiterate. Typically, they are tailors, cotton workers, embroiderers, or flower vendors who have organized themselves into self-help groups. Jana Centres use these small batch loans as a gateway product to introduce them to disciplined borrowing and repayment. The progression from the small batch loan to the individual nano loan represents a borrower inflection point in two regards: formalization and entrepreneurial aspiration.

Having borrowed amounts of ₹125,000–₹150,000 ($1,900–$2,300) through several small-batch loan cycles, nano loan applicants will have been closely monitored during Jana Centre training sessions.[22] Only 20% of small batch loan borrowers apply for nano loans, of which only 20% are successful, so the graduation channel is narrow. Ranging from ₹60,000 to ₹200,000 ($920–$1,845), Janalakshmi views the nano loan as the tool for "business road map establishment." It includes financial advisory services focused on expenditure allocation, expenditure management, and savings. Significantly, nano loan customers are provided with bank accounts and checkbooks, a step with enormous esteem in Indian society, especially in low-income segments. A sense of independence also derives from financial privacy, which is not possible in the small batch loan context, where all borrowers are aware of each other's financial affairs.

The bridge from retail to enterprise financial services. Although Janalakshmi was successful in the onboarding to expansion journey for poor female borrowers, the leap to unsecured MSME products was more challenging. In 2010, Janalakshmi launched an unsecured loan product of up to ₹2.5 million ($39,000), believing that this would provide a competitive advantage over various secured products on the market. It soon realized, however, that the product was doomed by adverse selection, as it was attracting borrowers declined by other institutions. The interest rate was also too high. This misstep, however, informed the design of its much more successful emerging microloan.

Indeed, Janalakshmi spent nearly 1.5 years researching, testing, and refining the emerging microloan. The key question was how to assess borrower risk (i.e., the quantitative and qualitative tools to use). One tool Janalakshmi developed was the degree-of-formalization concept, which evaluates a prospective borrower's familiar indicators (e.g., age, lifestyle, business ownership, and financial information) and includes a psychometric test. Product development and testing also involved intense engagement at the hectare level, especially client referencing and community checks—leading to an unexpected revelation. Despite Janalakshmi's deep penetration of catchment areas, it appeared that some 50% of MSMEs remained unserved. Moreover, researchers realized that semiformal and informal MSMEs were not operating independently of their peers, but in continuous interaction and exchange with them. Therefore, Janalakshmi understood that if the financial circuitry could be re-laid to catalyze individual and enterprise expansion, overall local economic growth could be accelerated and greater wealth generated. This, in turn, implied increased business for Janalakshmi.

[22] Regular attendance is expected.

Through six full-time staff members working on the pilot, six sectors— construction, transport, health care, logistics, eateries, and education—were identified for small training centers, schools, and day care centers. Initially, the emerging microloan "sweet spot" was expected to be ₹300,000–₹500,000 ($4,615–$7,690), but it soon became evident that this was too big and that the gap in business acumen and level of formalization was too great. Reducing the average loan size to ₹100,000 ($1,540) yielded better results, but the key breakthrough came on the collection side. Cash-flow volatility was still too high for the borrower of ₹100,000 to meet monthly repayment installments. The vendor who ended the day with ₹600 ($9) in cash faced numerous pressing expenditure needs. Moreover, once in a husband's hands, it would invariably be unwisely spent. These realities led Janalakshmi to reduce collection frequencies. Conversion from equated monthly installments to equated daily installments reduced arrears and default risk, alerted borrowers to the concept of medium-term profit and loss, and introduced a savings culture.

Launched in the first quarter of 2016 with about 250 clients, some of whom were nano loan graduates, by April 2016, ₹50 million ($770,000) of emerging microloans had been disbursed with a 100% repayment record. As of May 2017, ₹100 million ($1.54 million) of emerging microloans has been disseminated to hundreds of clients through 68 Jana Centres across the country, with a recovery rate of 95%. This has benefited Janalakshmi enormously, because it provides a safer launch pad for enterprise financial service products designed for more formal micro and small enterprises. To qualify for these products, the borrower must have successfully completed two or three emerging microloan cycles and accumulated assets. Eventually, this allows the borrower to be considered for secured MSME lending products, which range from ₹1.0 million to ₹2.5 million ($15,400–$38,500).

Harnessing technology to service the urban missing middle.[23] Having re-seized the unattended urban missing middle opportunity, Janalakshmi is now applying technological innovation to the individual entrepreneur and micro and small enterprise segments. It sees digitalization as key to achieving economies of scale, client retention, and capture, aware that it cannot rely on foot traffic to Jana Centres for new business. Leveraging India's prowess in low-cost digitalization, with the national Aadhaar biometric identity card program in mind, Janalakshmi is using technology to accelerate and update client onboarding, account monitoring, and credit referencing. The Aadhaar program will help facilitate data capture and management, and enable hundreds of millions more Indians to establish credit histories.

From an internal cost and efficiency perspective, technology is also being used to take full advantage of densification. Janalakshmi has partnered with IBM to create a data warehouse, smartphone applications, and niche investment solutions. It is currently exploring the use of GPS technology to optimize repayment collection routes depending on changing client locations—a vendor may move her stall several times a day, for example—and thereby maximize daily contact with clients. Similarly, it is investigating whether heat mapping can be used to provide real-time alerts to clients in locations with the greatest crowd density. Finally, it is looking to introduce geotagging so that cash collection can be monitored remotely and attacks on collectors reduced.

[23] The term "missing middle" denotes the common absence of debt and equity available to MSMEs from formal financial institutions.

Despite applying technology where beneficial, Janalakshmi is not seeking to replace cash. On the contrary, not only is cash the familiar medium of exchange in urban India, but it also it provides the touchpoint for client–lender engagement. Just as the densification strategy is predicated on deep customer relationships, these are lubricated by cash disbursals and repayments.

Future growth. As highlighted previously, Janalakshmi's alley-by-alley, street-by-street research indicates that the number of MSMEs in India may be as high as 120 million, double the official figure of 60 million. If this is the case, just 7.5% of firms currently have access to formal financial services in India, half of the official estimate of 15.0%. Therefore, Janalakshmi is redoubling its focus on the urban missing middle, aware that it has not even scratched the surface of hundreds of third- and fourth-tier Indian cities. Having been licensed to receive deposits by the RBI in May 2017, Janalakshmi can reduce the cost of funds with which to penetrate such cities by ramping up savings products, enabling it to develop new products and solutions for micro and small enterprises and individuals who, according to V.S. Radhakrishnan, Janalakshmi's managing director and chief executive officer, "are vital because we can already see that asset and liability products will stagnate over time. We cannot simply rely on client graduation in the long term."

Products include cash-flow loss or interruption insurance; peripheral risk insurance, covering unanticipated losses where the borrower is not at fault; pensions; microhealth insurance; and other specialized contingency products. Janalakshmi's strategy is to match business formalization with an appropriate suite of products that act as training wheels, stabilizing emerging enterprises for continued growth. Meanwhile, as wealth accumulation accelerates among the entrepreneurial BOP segment, burgeoning demand for home ownership and mortgage finance are anticipated. Janalakshmi is now strategically positioned to mold proven methodologies for accommodating BOP cash-flow volatility to new mortgage products.

The strength of Janalakshmi's conviction in the urban missing middle, and its ability to culture micro and small enterprises with financial products, is evidenced by current thinking on additional professional service offerings. Janalakshmi is already anticipating the needs of the MSME that, in time, takes on 10–15 employees, such as bookkeeping, accounting services, payroll management, general sales tax registration, and compliance. As V.S. Radhakrishnan noted, "Interest rates on loans will come down. They must. Hence, we have to evolve; we have to build and service this untapped market of the future with the full range of services required."

Rethinking the dynamics and needs of the urban entrepreneurial landscape. This case study underscores the significance of social capital for financial inclusion and IB financing at the BOP level, and the relationship between the two. Janalakshmi's painstaking penetration of a hectare sector enables a Jana Centre to both comprehend and integrate itself into a community. Tailored financial inclusion methodologies and deep client relationships, cemented by continuous training, allow each Jana Centre to replicate, to some degree, the engagement central to the investor–investee relationship in private equity. Disciplined repayment, daily cash collection, savings, and product insurance impart financial skills to borrowers that help anchor small businesses. As a result, the urban inclusion cluster becomes more dynamic, and its engagement with and insertion into supply and value chains intensifies.

3. Tethering Expansion to Product Entrenchment: LOLC[24]

Financial institutions can expand IB financing operations in numerous ways such as developing new products, targeting new market segments, opening new branches, enhancing online presence, or launching services in new geographies. A methodical approach, however, is essential to the successful expansion of any kind; for Janalakshmi, Jana Centres were systematized. The resilience of the institutional underpinnings that this requires (e.g., logistics, operations, and management) cannot be overlooked, nor can the replication of strategies from one region or country to another.

Moreover, the opportunity cost, and implications in financial and reputational terms, are significant. Financial institutions must ensure that feedback loops are robust and that the institutional memory of past errors and successes is maintained. Evidence-based decision making and measured risk taking must also be balanced. An element of uncertainty will remain inevitable, however, but drawing on past experiences and undertakings with thorough product costing, setting milestones, ensuring resource availability, and communicating transparently with management, are critical. The following case study on Lanka ORIX Leasing Company (LOLC), an institution from Sri Lanka that is now also present in Cambodia and Myanmar—and has been invited to launch in Pakistan and beyond—is instructive in these areas.

From leasing to inclusion. LOLC was founded in Colombo, Sri Lanka in 1980 as a specialized leasing company focused on the industrial equipment and transport sectors. For over 2 decades, LOLC's main business consisted of leasing and lending for vehicle purchases. Despite civil war and political turmoil in Sri Lanka, business grew steadily; however, as a NBFI, LOLC was dependent on commercial banks for its funding requirements. To circumvent this dependence, in 2002, LOLC formed LOLC Finance (LOFC), a wholly owned subsidiary of the parent company.

LOFC set about using savings accounts and term deposits to generate liquidity. This entailed building a book of businesses from scratch by reaching out to the underbanked. It was the commercial imperative of building a business, not a social mission, that precipitated LOLC's foray into financial inclusion and, eventually, IB financing. LOFC then took the view that if it were to concentrate on the underbanked, it should finance income generation. Lending would necessarily be cash flow-based owing to the BOP's general lack of assets, and while appropriate credit appraisal methodologies were elaborated, LOFC intuited that financing for commercial purposes would reinforce lender–borrower alignment.

LOFC began by financing motor vehicles and developed a platform of leasing and hire-purchase products for the BOP. Internally, LOFC created margins through fiscal arbitrage by designing products with identical cash flows despite being packaged as loans, leases, or hire-purchase. From the client's perspective, the nature of the product did not matter, but this gave LOFC the flexibility to capitalize on the fiscal benefits of the different financial products.

Client education, engagement, and retention formula. Several characteristics of BOP lending soon became clear to LOFC. First, because borrowers had little or no financial experience,

[24] All information in this subsection is taken from an author interview with Brindley de Zylva, Chairman LOLC (Cambodia Plc), Managing Director, LOLC Myanmar Microfinance Company Limited. Interview was conducted in 14 May 2017.

they required intensive training. This implied a high-touch model that was cost-heavy at the front end. Second, not only was there no understanding of indebtedness among borrowers, but they were also oblivious to the time-value of money. The impact, from the moment of disbursement, of interest payments over time did not resonate with borrowers. Third, LOFC needed to take greater account of cash-flow volatility of the BOP and modify its reaction to payment arrears. LOFC realized that arrears and intention to repay were different. Over the years, it became comfortable with 1- to 3-month payment arrears provided that a client intended to make repayments. This was partly because LOFC had invested heavily in client relationships but also because client engagement with LOFC gave clients access to a range of products from initial financial inclusion to IB financing resulting in high client retention.

Savings as a pillar of growth and geographical expansion. A lesson learned from LOFC's penetration of lower-income segments in Sri Lanka is the importance of a holistic approach to financial literacy, that is, the provision of lending or credit facilities alone is insufficient for building a long-term business based on client retention. Active participation in clients' cash flow and transactional requirements and, more broadly, their wealth accumulation trajectories is essential, and must be underpinned by product offerings. For LOFC, remittances, savings, and insurance have become central to this nexus. It has also informed LOFC's penetration strategy for these new markets:

(i) **Remittances.** With an estimated one-quarter of Sri Lanka's rural population reliant on remittances, LOFC launched a remittance product in 2009. By mid-2010, the business line was generating $300,000 of monthly profits. LOFC was forced to phase out this business, however, as the heightened scrutiny of international money transfers and correspondent banks saw the introduction of unwieldy anti-money laundering checks. Although transaction volumes and profitability of the remittance business outstripped expectations, it taught LOFC a valuable lesson: early cost-recovery on new products, ideally within 1 year, is a vital indicator of product viability.

(ii) **Savings.** LOFC realized the importance of savings products from a commercial perspective, as they lower its cost of funds. Culturally, however, for lower-income segments sensitive to daily cash-flow fluctuations, depositing cash at the bank was counterintuitive; the notion that wealth accumulation (i.e., savings) could be the basis for accessing credit was unfamiliar. Yet over time, the catalytic effect of having convenient access to their savings drew clients to the product. It also enabled LOFC to leverage relationships to issue debit cards, which provided clients with ready access to cash through ATMs and for point-of-sale transactions.

Savings also provided a conduit to credit services both at the individual and staff levels. Indeed, LOFC applied strategic lessons from its experience with savings in Sri Lanka to its market penetration strategy in Myanmar, where it began lending operations in 2013. Brindley de Zylva, managing director of LOLC Myanmar Microfinance Company Limited, sought to introduce a savings culture among staff at the fledgling operation in Yangon. Having entered the Cambodian market in 2012, LOLC was well aware of the value of in-house dynamics for product testing.

Further experimentation led LOFC to develop two further savings products. In Sri Lanka, it offers loans to employees based on their savings track record, permitting them to borrow against future wages. It also introduced a minors' savings product, a key tool for encouraging financial literacy early and inculcating a savings culture. These savings accounts can be opened with as little as SLRs1,000 ($6.45). If children

consistently deposit a monthly sum—even as low as SLRs10 ($0.06)—they receive free schoolbooks annually until age 18 years. Children cannot access their savings until they reach age 18 years; from LOFC's perspective, a regular touchpoint with the institution has been established, and the young adults are likely to remain clients.

(iii) **Insurance.** LOLC formed an insurance company in 2010. Although it had been active in insurance through brokers, leveraging the captive client base that had been developed through vehicle financing was an attractive proposition. Its general and life insurance practices were segregated in 2015, and accounted for 5% and 3% of total market share in Sri Lanka, respectively. The relevance of the insurance business is how initial product positioning influences LOLC's approach to tackling additional, progressively lower-income market segments. It is now offering microlife insurance and micro healthinsurance products to low-income customers. LOLC is pursuing a hub-and-spoke approach to product development, fanning out from its core captive market to downscale into lower-income groups.

Launching operations in Myanmar. LOLC has adapted its methodology to the Myanmar context. Years of economic isolation and mismanagement have kept millions of people in Myanmar in grinding poverty, but the initial focus of LOLC's lending activities is, as Brindley de Zylva stated, "at the apex of the base of the pyramid." This does not imply rapacious profit seeking; on the contrary, it is a measured approach based on experience. As he builds LOLC's Myanmar business, Mr. de Zylva is seeking to establish basic lending and savings products, build a book of business that has critical mass, and then address adjacent segments. This initiate–consolidate–evolve approach can be seen in the portfolio data. Since 2013, the average loan size has increased from $150 to $400, and the rate of graduation from group to individual loans has accelerated. About 97% of borrowers are women. LOLC has structured its offering so that clients maintain compulsory savings, amounting to 4% of borrowing. The success of LOLC's financial literacy programs and the impact of the microlending model can be measured by borrowers voluntarily maintaining a savings balance equal to compulsory savings.

Learning from missteps. LOLC's product development methodology and its approach to new market segments provide insight into aspects of financial inclusion that are vital for successful IB financing. LOLC admitted that learning from mistakes has been critical in this regard. Such was the case with an ill-fated clean energy initiative in 2004. The clean energy product-financed solar panel installation on the homes of the rural poor. Despite clear household-level benefits (e.g., children being able to study at night), the absence of direct economic utility of solar power severely impaired repayment. Unlike borrowing to purchase a tractor, solar panels yielded only secondary benefits, not income. Hence, loan defaults and even repossession generally met with client inertia. LOLC drew two conclusions from this, which have guided new product development ever since. First, clarity of purpose is essential. As Mr. de Zylva stated, "You have to be crystal clear whether you are lending to collect the money or lending to sell. You cannot lend without full intention to collect." Second, economic utility to the household is the key repayment variable. According to Mr. de Zylva, "If you try to sell a product, it will not work. If clients want a product, if they need it, if they are hungry for it, they will pay."

Although this case study may seem more concerned with traditional financial inclusion, it provides important insights into the relationship among borrower psychology, product viability, and product iteration. In this regard, LOLC's focus on cost was essential. It undertook

in-depth analysis of prospective products and target communities, cognizant of shareholder expectations. Management triangulated between stakeholders and the realities and challenges at the ground level. Commercial viability drove product development rather than social mission; this tenet ensured the financial stability of LOLC and enabled it to penetrate poorer social strata. To financial institutions that service larger market segments, LOLC is aware that it is a significant conduit for emerging entrepreneurs and microenterprises. As such, its contribution to the IB financing ecosystem is the inculcation of disciplined borrower repayment habits and a focus on the productive potential of assets for which financing is sought.

C. Conclusion

The scale at which financial institutions can provide capital to IBs is unparalleled. Dwarfing the fund modality, it makes financial institutions particularly important actors in the provision of IB financing. The case studies in this section suggest that a rigorously commercial approach to BOP incumbents and MSMEs is critical to the viability of inclusive financial products serving them. Although financial institution lending volumes do not afford high-touch customer engagement, vital skills and learning are still transmitted through the relationship, such as financial literacy, a savings culture, cash management, and disciplined repayment. This helps establish foundations for commercial viability, regardless of the size of the commercial endeavor. Importantly, it also confers greater livelihood security. At larger loan size levels, financial institutions find themselves at the center of supply and value chain-building opportunities. These can be unlocked if small-scale, inclusive nodes of entrepreneurial activity are formalized, and if they are considered as business clusters whose aggregate, robust relationships with offtakers allow for creativity in product design and collateral assessment.

IV

The Role of Private Equity Funds in Inclusive Business Financing

A. The Evolution of Private Equity Funds in Inclusive Business Financing

The second modality for deploying capital in inclusive business (IB) is equity, which is often aggregated in funds. Given micro, small, and medium-sized enterprise (MSME) cash-flow sensitivities and the pressure of debt repayments (i.e., interest and principle) on scarce resources, equity investment can be less burdensome. Further, when well executed, private equity is often accompanied by strategic engagement in nonfinancial areas, which is often as critical as the financing.

Private equity has been a prominent development financing tool for decades, yet the smaller the company targeted, the more awkward the fit. Consequently, the rebranding of private equity as "impact investment funds" from mid-2000s is stretching the fund modality to the breaking point. Private equity should indeed remain a first-order IB financing tool, as it has the potential to attract large amounts of private capital and to transform companies, but unless fund managers and industry advocates correct design flaws specific to the IB context, as well as clearly segment private sector-ready products from experimental products, private equity will continue to perform suboptimally as an IB financing tool.

1. From MSME Funds to Thematic Funds, 1989–2009

In the late 1980s, the Commonwealth Development Corporation (now known as the CDC Group, hereinafter CDC) the United Kingdom's development finance institution, began to adapt private equity fund structures pioneered in developed markets to developing countries. According to Robert Binyon, who set up CDC's MSME Funds Group in 1994, "CDC had two objectives at the time: to channel third-party capital into developing economies, and to make profitable investments in companies that we thought vital for equitable, enduring growth." That a DFI took the initiative partly reflected the realization of MDBs that they lacked the bandwidth for direct MSME investing in many countries. Moreover, providing credit lines to local commercial banks for MSME onlending had been unsuccessful. Credit appraisal methodologies were rudimentary; loan officers lacked appropriate skills, were underresourced, and were unqualified to mentor borrowers; and perverse incentives encouraged loan volume over loan quality.

With offices across Africa, Asia, and Latin America, CDC launched its initiative with a $5 million vehicle in Papua New Guinea in 1989. A challenging economy even by emerging market standards, the fund targeted start-ups, early-stage growth transactions, turnarounds, and rescues. CDC executives involved at the time recalled that such deals were thought to generate significant financial returns—the fund's target net internal rate of return (IRR)

was 22%–25%—and would contribute to development. Anecdotally, they recounted that development was defined as stimulating economic growth by getting financing to MSMEs. Poverty reduction was an implied, if not explicit, goal.

In hindsight, the boldness of the CDC experiment is striking. It was unversed in funds, and no European DFI had invested in or managed them. Furthermore, private equity as an asset class was unknown in most developing economies. Few had appropriate legal and regulatory frameworks, and fiscal authorities did not know how to treat fund vehicles, carried interest, or capital repatriation. MSME private equity funds were a pre-emerging asset class.

Although the Papua New Guinea initiative ended in disaster with an IRR of –35%, CDC was undeterred. Between 1989 and 1999, it established 14 single-country and regional funds in Central America, the Pacific island countries, South Asia, and Sub-Saharan Africa, undertaking over 100 transactions with $140 million under management. In 2001, a new entity was created to manage the fund portfolio, Aureos Capital, a joint venture between CDC and Norfund. Its mandate was to manage out the CDC funds; use the lessons from the legacy fund portfolio, then projected to produce IRRs of –35% to 8%; and create a new fund management business. CDC and Norfund, who were owners of Aureos and anchor investors in its funds; investors from Africa, Asia, and Latin America; banks; pension funds; insurance companies; MDBs; and European DFIs believed that the reformulated investment strategy would generate attractive financial returns. The investors also sought to understand the development impact of the funds; although the impact was not rigorously defined, it foreshadowed the emergence of impact investment and IB funds in the mid-2000s.

To investors' surprise, an unlikely aggregate cash multiple of 1.8 times was achieved on the legacy portfolio, though individual fund IRRs varied wildly. The lessons from the CDC experiment must be revisited by today's impact investment and IB fund communities for two reasons. First, current offerings are repeating many early design flaws. Second, the introduction of explicit social/environmental objectives in fund designs, such as impact or inclusion, make an already challenging modality even more complex. The key takeaways from the CDC legacy portfolio are presented below.

2. Key Lessons Learned

Fund parameters and fund structure. MSME private equity requires the fund manager to engage in most aspects of investee operations. This necessitates seasoned equity investment executives, usually in short supply in emerging markets. It also makes retention paramount, which requires the ability to compensate staff well over fund lives, typically 10–12 years. Even with annual management fees of 3% on committed capital,[25] it was clear that vehicles capitalized with less than $40 million were insufficiently resourced to create and to manage portfolios of 15 or more deals.[26] For example, the Aureos Central America Fund, raised by Aureos in 2002 and capitalized at $36.3 million, covered 7 countries from 3 offices with 10 staff members and a target deal size of $500,000–$3 million.[27] Clearly, the annual management fee of $1.09 million was insufficient to fully cover operating costs, salaries, travel, and other recurring expenses. Furthermore, because management fees are levied on cost, not capital

[25] Common in the 1990s, now usually 2.00%–2.25%.
[26] Small average transaction sizes meant that portfolios of 15, 20, or even 25 portfolio companies were not uncommon.
[27] The target fund size was $50 million, but fundraising became difficult after the tech bubble burst.

commitments, resources available to the fund manager declined with each exit from the end of the investment period onward.

The implications of this basic fund arithmetic are obvious in hindsight—below a certain threshold (e.g., $50 million), management fees barely cover costs, let alone afford deep investee engagement. Further, the more complex the fund—by geography, transaction profile, or theme—and the more transactions done, the more intensive the hand-holding needed. Finally, the smaller the average transaction size, the larger the portfolio, squeezing resources still further.

Thus, the arithmetic linking fund size, geography and tenor, average deal size, deal profiles, and headcount is essential. Absent subsidies or additional revenue streams to the house from other funds or business lines, it is uneconomical to combine small funds and small transactions. As donors and DFIs cannot pay annual management fees of 4%–5% or higher, the amount needed to manage such funds effectively has been obscured by using TA funding. This said, very few DFIs allow managers to use TA funding for running costs.

Transaction profile and size. Venture capital, start-ups, early-stage growth companies, turnarounds, rescues, and recapitalizations are much riskier than larger deals. For this reason, funds focused on them usually offer higher returns. The same applies to transaction size. A $250,000 investment in a start-up almost always requires more time from a fund manager than a $4 million expansion capital transaction.

Thus, fund design must triangulate between fund size, transaction profile (i.e., risk profile), and average transaction size. With this in mind, it can be seen how unlikely the CDC fund in Papua New Guinea was going to succeed. It was capitalized at just $5 million with a target deal size of $50,000–$500,000 and an exceptionally demanding investment strategy. Although it was able to draw on local infrastructure (14 offices across Africa, Asia, and Latin America) and administrative services provided by CDC London headquarters, Aureos estimated that some £20 million–£25 million (around $40 million) had been spent setting up the necessary physical infrastructure worldwide. This was done long before the establishment of Aureos, so it had not been priced into the cost of Aureos as a stand-alone business. Thus, for a new fund manager to establish a physical presence in one or several areas, significant resources would be needed.

Fund geography. Of the 14 funds raised and managed by CDC, 11 were country funds and 3 were regional funds. The merits and drawbacks of a single- and multi-country approach emerged over time. Clearly, covering one country is cheaper and more manageable than several of them. From an administrative and operational perspective, it removes the need for cross-border fiscal, legal, and regulatory arrangements, which can be complex and expensive. Local presence and local teams are essential to effective MSME investing, and opening and maintaining offices is a large line item in any fund budget. This said, from a performance perspective, the risk profile of country funds can be high. Exposure to macroeconomic and political volatility, currency depreciation, and ad hoc policy changes is total. For instance, in the case of the Ghana Venture Capital Fund, raised by CDC in 1994, currency depreciation of over 1,000% translated an impressive local currency IRR into double-digit losses in United States dollar terms. By the same token, the strictures of single country funds can also

spark innovation. For example, as the Zimbabwean economy nosedived in the early 2000s, CDC's Takura Fund took as many investees regionally as possible, generating earnings in multiple currencies and maintaining a positive United States dollar IRR.

The advantage of regional funds is diversification. Portfolios can anticipate and react to country risk by shifting geographical focus. Regionalizing businesses can be easier when funds have local teams in various countries. Where competition for deals is vigorous, a fund manager's ability to realize a sponsor's regional expansion plans can aid deal sourcing and execution. Nevertheless, regional funds have challenges. Beyond the infrastructure expense, it can be hard to achieve team cohesion, especially when country conditions and quality of investment opportunities vary. If asymmetries persist, team members in buoyant countries or subregions may begin to question peers. They may demand that salary and carried interest arrangements be revisited. In extreme cases, spinoffs by one country or subregion can pose an existential threat to the house. Strong management is key here, a rare quality in private equity.

Regional footprints can also cause conflict on three levels: within the management team, between the fund manager and investors, and among investors. Stakeholder geographical priorities and risk appetites may differ. Where some team members see opportunity, others may see unwarranted risk. The status of individual portfolio companies may be cited as evidence. Where some investors stress return maximization, others may value the economic and developmental benefits of making available risk capital in distressed geographies. Further, there may be disagreement on country allocations as the investment period ends. Resolving these issues is challenging unless the fund investment policy provides clarity.

Therefore, fund geography must be carefully scrutinized during fund design. Country risk cannot be considered in isolation, and no country or region affords a stable 10-year view. Private sector and financial sector depth matter—that is, the size of the potential investment universe, sophistication of the business community, availability of debt and equity (i.e., competition and likely effect on valuations), capital market depth, and liquidity. It may be argued that India or the PRC are sufficiently deep markets to carry a single country strategy, whereas a Myanmar-only fund gives pause. Additionally, the professional experience, track record, and cohesion of the investment team must be evaluated against the difficulty of the proposed geography, as well as target deal profiles—critical for new fund offerings especially.

Exit planning and execution. The fund manager must be focused on exit from screening onward. An exit plan must be discussed with sponsors during due diligence, and reviewed regularly. Further, to the extent possible, multiple investment instruments and structures must be used to generate liquidity during the holding period. In other words, cash-generating opportunities (e.g., income, dividends, or royalties) must be sought throughout the investment life. Relying on sales of equity stakes alone is risky.

Exit viability, usually referred to as liquidity risk, concerns fund managers and investors in all markets. It is a function of many factors (e.g., macroeconomic conditions, financial/capital market depth, and legal and regulatory environments) and fluctuates over the fund life. Nevertheless, exiting small transactions is much harder than exiting large ones. Further, it must be noted that well-managed, well-governed businesses rarely struggle to find buyers, even in the most challenging markets. The scarcer such businesses, the more coveted they are.

Portfolio divestment is often more challenging than portfolio construction. All aspects of fund design must take exit viability into consideration. The manager must plan for all contingencies throughout the investment cycle. Cash generation can have a significant bearing on the financial health of the fund management company (i.e., fund profit and loss); currency risk mitigation (i.e., returning reflows to investors in the base fund currency over the fund life); and reducing the difference between gross and net returns.

Fund returns. Fund returns are a function of the above factors combined with others. Of all of the lessons from the CDC legacy portfolio, one in particular stands out: every fund offering promised a net IRR to investors of 22%–25% in United States dollar terms, but net IRRs ended up ranging from –35% to 8%. Today it is known that small funds composed of small transactions do not generate such returns; a "home run" from one investee could, in theory, produce such a return at the portfolio level, but this is highly unlikely. More to the point, would this not be a venture capital offering, likely demanding even greater returns for risk incurred? Would it not undermine the rationale for aggregating risk capital to enable growth in as much of the MSME sector as possible?

It is key that fund managers and investors interrogate return projections thoroughly. Investors are learning to do so, but fund managers are often inclined to exaggerate. Perversely, many feel compelled to exaggerate to attract investors. More dangerously still, new and even second-time fund managers lack the experience or impartiality to triangulate the investment thesis with portfolio construction and fund operating costs. Few managers are brave enough to underpromise and outperform.

Without the 10-year CDC experiment, the fund management community and availability of risk capital in emerging markets would be diminished. As Aureos and its peers developed investment theses, as well as fund and management company models, MSME funds became recognized as a significant development finance strategy and, in some cases, a source of attractive financial returns. Over the same period, consensus was building among development financiers and academics that the contribution of the MSME sector to economic growth, private sector development, and poverty reduction had been underestimated. More compelling still, the aftermath of the global financial crisis and ensuing economic slowdown revealed that many emerging market MSME portfolios had proved robust and were uncorrelated to developed markets and mainstream asset classes.

Two important developments occurred over the same 10-year period. First, capital deployment for positive social and environmental outcomes, as well as financial returns, gained a name: "impact investing." Second, the impact investment tent expanded from sector/thematic funds, such as health care, education, agriculture, or access to finance, to IB funds. J.P. Morgan, the Rockefeller Foundation, and Global Impact Investing Network prophesied with arriviste alacrity the birth of this new multibillion-dollar asset class in a seminal joint publication in 2010, which implied that billions of dollars of capital would inevitably flow into impact investing opportunities.[28]

[28] J.P. Morgan, Rockefeller Foundation, and Global Impact Investing Network. 2010. *Impact Investments: An Emerging Asset Class.* https://thegiin.org/assets/documents/Impact%20Investments%20an%20Emerging%20Asset%20Class2.pdf

Box 8: Voices of Practitioners—Unlocking Investment in Inclusive Business

Alice Chapple is the founder and director of Impact Value, a consultancy that advises fund managers and inclusive businesses on how they can generate the greatest impact with their activities.

Productive and income-generating opportunities in the developing world depend on the development of small and medium-sized enterprises (SMEs). The World Bank estimates that four out of every five new jobs are, and will continue to be, created by SMEs. These SMEs desperately need capital, which currently tends to flow to big business or to microfinance institutions, missing the middle. SMEs play a critical role, not only on their own terms but also in relation to the large and small ends of the business spectrum. Large businesses have a commercial imperative to find reliable SMEs to support their supply chain, while microbusinesses must grow and professionalize. Yet despite their crucial role in a functioning economy, it has proved difficult to find models that can deliver capital efficiently to these inclusive SMEs. In part, this is because the cost of providing necessary business support is high in relation to the size of the loan. Without that support, an SME often struggles to deliver proper financial accounts, find new markets, manage health and safety or environmental risks, or bring in the technical expertise required for growth. When that support is available, the success rate for SMEs can be transformed—for example, in the portfolio of one SME fund manager, GroFin, 80% of the investments have reached commercial viability.

The need is clear, and finding new ways to provide financing to SMEs continues to be an urgent challenge. This may be achieved in part through the growth of traditional channels of funds and financial institutions, with development finance institutions (DFIs) potentially providing blended financing to share risk with other sources of capital. There are some signs that some DFIs are strengthening their strategies in support of SMEs, recognizing and accepting the need for more patient capital and greater technical assistance. The Impact Fund, a fund of funds managed by the Commonwealth Development Corporation, and a partnership between the Netherlands Development Finance Company (FMO) and the Shell Foundation, are both examples of this.

Attempts have also been made to enable investment in SMEs by a wider group of private investors seeking impact alongside financial returns. The Impact Investment Trust sought to raise $150 million for investment in SMEs through a flotation in London in 2017. While many investors expressed interest, this type of investment faces the challenge that impact investors have a range of differing expectations about impact and returns, and it is not always clear how the investment proposition will manage these two factors. Some investments will be able to combine high impact with solid risk-adjusted returns, or appeal to investors looking for assets uncorrelated with their existing portfolio. Other investments require a more patient approach, entail more risk, and need more hands-on support; inclusive business investments are likely to be in this category. To make a choice that is right, impact investors need to be provided with clear information on where an investment sits along that spectrum.

Emerging digital financial technology, or fintech solutions, present opportunities to reach customers more cheaply, assess creditworthiness more effectively, and aggregate SMEs to enable economies of scale. These are being actively explored by a financial sector development program based in Nairobi, Kenya, FSD Africa, and others. Larger, more systemic solutions are also being explored. For example, the work of Frontclear is designed to strengthen legal securities so that international banks can lend to smaller local banks, thereby increasing the capital available in local currency to SMEs.

As new approaches are developed to reduce the cost of providing capital to SMEs and to catalyze new sources of funding, it is important that one of the key lessons of the past is not lost. For a small and growing inclusive enterprise, financing is only part of the story. Early, patient, and responsive support is also critical for enabling inclusive business to flourish.

Even by the broadest definition, however, only a fraction of these inflows has materialized—chiefly because expectations were unrealistically raised. Another reason is confusion among mainstream investors (i.e., pension funds, university endowments, and foundations) about what exactly was on offer. Were such impact investing opportunities commercial offerings? Were they developmental offerings? Hybrids? Would they stand investment committee scrutiny? Did fiduciary duty allow for them to be considered?

Understanding the history—that is, where the impact investment narrative went astray and how to clarify it going forward—is crucial to unlocking more capital into the sector. Meanwhile, introducing the explicit goal of realizing impact or business inclusion, however defined, had three vital outcomes: it raised expectations of impact and IB strategies even higher; it increased the complexity of a still unmastered tool applied by nascent practitioners; and, as a result, it further strained fund architectures, themselves still works in progress.

B. Recognizing and Mitigating Challenges in Inclusive Business Fund Design

1. Conceptual Issues of Inclusive Business Fund Design

It may be that IB funds—perhaps all impact funds—have an inherent weakness. It may be that our best option is to strengthen the musculature around the weakness. The weakness is this: traditional private equity funds posit a fiduciary relationship between asset owners and asset managers. Asset owners place capital with asset managers for them to deploy in agreed investment strategies to maximize financial returns. Restrictions may exist (e.g., sectors, countries, or sponsors may be excluded). There will almost certainly be environmental, social, and governance (ESG) regulations as well. Yet a fund's objective and investment policy and the fiduciary responsibility of the fund manager are unambiguous.

Injecting nonfinancial objectives, such as business inclusion or any impact strategy, introduces a mutation, however, as the fiduciary vector has been divided. Financial and nonfinancial priorities must now be weighed and reconciled. Further, the mutation comes in degrees—some are benign (i.e., manageable) and others are malignant (i.e., jeopardizes fund viability). Managers with limited fund design experience are unlikely to spot potential malignancies when designing investment strategies. Yet if they cannot spot them ex ante, how will they know to mitigate them? At the same time, investors are also unversed in these intricacies, as well as the first-order challenges outlined in Section III. Impact offerings do sound compelling, and enthusiasm for nonfinancial objectives, especially where traditional development interventions have disappointed, can distract from proper interrogation of fund substructures. Romanticizing the impact thesis dilutes the first-order question of whether an investment strategy is viable, impact and all.

Factors that can negatively influence an impact fund are presented in Table 2. The first column identifies the factors, and the second offers strategies for resolving them.

Table 2: Impact and Inclusive Business Fund Design Challenges and Mitigation Strategies

Design Feature	Issue	Remedial Strategies
Transaction size and type	Around the mid-2000s, when impact strategies were introduced into private equity, the microfinance community and DFIs were tackling two questions: (i) Why had so few microentrepreneurs graduated from initial microfinance loans to become small then medium-sized enterprises? (ii) If upscaling through microfinance was sporadic and protracted, and downscaling by MSME banks rarely worked, who would finance the missing middle and by what means? These questions diverted the attention of managers and investors to start-ups and small, early-stage transactions, largely oblivious to their higher risk profile. Hence, the earliest impact managers, although pioneering, mobilized capital to address the missing middle with a poverty reduction narrative that was exaggerated. It was exaggerated not because the need for capital and potential of the latter for poverty reduction were absent, but because of the long gestation periods and risk profiles of the deal types. In other words, the delivery mechanism was ill-suited to the task. Compelling as the social call to arms may have been, the true risk profile was borne out by high investment mortality rates and stagnating portfolios. Worse still, the explanation given by some managers was that those genuinely focused on the BOP would suffer many failures and that the J-curve for this market segment was simply longer. Regrettably, while managers warned of drawing premature conclusions from young portfolios, a false equivalence was established between small deals and impact. Some of the first managers targeting social enterprises sought to embed the notion that 'small is developmental'. In its most hostile manifestation, a narrative emerged that $250,000 investments in unproven start-ups (e.g., solar lantern or cookstove companies) were "real" impact investing and showed true commitment to the poor, whereas larger investments in established businesses simply sought to make money off of the poor.	Small transactions are riskier and more resource-intensive than large transactions. Start-ups and early-stage deals are particularly risky. The foundations for commercial success (e.g., good management, financial acumen, effective systems, and financial controls) are scarce, more so in small businesses. That such businesses struggle to access financing is beyond doubt. The question, however, is whether small funds composed of small deals designed and managed by young teams are a viable way of deploying capital. The viability is further jeopardized by the fact that few investment executives have enough experience in traditional fund management to anticipate the complexity of their emerging-market venture capital strategies that they wrongly see as private equity strategies. Naturally, the compounded difficulties of impact also go undetected. These problems are hard to resolve. One or several of the following solutions may be needed: • DFIs, MDBs, and other impact investors should incentivize only the most experienced MSME fund managers to raise impact funds. • This said, the universe of impact managers must be expanded. Established managers with adjacent business lines, such as sectorally agnostic MSME funds, should be the ones encouraged to develop offerings. • Although not without challenges, joint ventures between experienced and emerging managers should be encouraged. • DFIs and donors must nurture emerging managers, not just by investing in their funds, but by collaborating in fund design and team composition, taking stakes in management companies, providing significant technical assistance, and, if needed, subsidizing management fees.

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Table 2 *continued*

Design Feature	Issue	Remedial Strategies
Scalability and replicability	Failed or languishing early-stage businesses abound. It may take years for them to break even and to reach profitability. To the already formidable challenges of launching and building businesses, the impact community has added the twin ambitions of scale and replication. Most coveted by investors and managers is scalability; a business is scalable when it gains critical mass and grows. The connotations of the word are troublesome, however. They include rapid proof of concept; rapid growth; positively affecting large numbers of people quickly; and, by extension, making speedy, discernible contributions to poverty alleviation. Replicability takes scalability one step further. It denotes the ability of a business model to be extended, duplicated, imitated, or hybridized elsewhere. Both ambitions are welcome. Why would resource scarcity not impel practitioners and funders to seek economies of scale and value for money? Yet it is unrealistic to expect scale promptly of young businesses. Moreover, the prominence of scalability and replicability as eligibility criteria and impact validators can cause managers to discard other opportunities whose potential for scale and replication may not appear to be as significant.	Investors and managers must temper expectations of scalability and replicability. Few start-ups are like Celtel, which introduced mobile telephones across Africa in the late 1990s, improving hundreds of millions of lives. It was sold in 2005 for $3.4 billion at a time when it had 24 million customers and operated in 14 countries. To anticipate even a fraction of this transformational change and poverty reduction potential from any business, especially from an under-$1 million start-up, is unrealistic. To the extent that scalability and replicability are valid objectives, they should figure in transaction evaluations, but with the following caveats: • not all business models can be scaled exponentially or replicated; • investment executives and investment committee members must set realistic expectations around scale and replication; and • they must be mindful not to discard local, context-specific strategies in favor of those that may be thought to be more scalable or replicable.
Financial returns versus impact	The lack of investment experience and romanticizing the impact story have produced the paradoxical notion that managers and investors can somehow choose the degrees of financial return and impact to pursue. To most chief investment officers, this is preposterous. If a business does not achieve and sustain commercial viability, the impact generated, no matter how profound, is time-bound. If the business ceases to exist, it can no longer have impact. Yet the impact-first-finance-first debate, as it is known, has gained legitimacy as if the trade-off were equivalent, a reflection of priorities or values. The framing of the debate is deeply problematic for various reasons.	Unless a business model realizes impact intrinsically (i.e., the commercial opportunity resides in addressing the social/environmental challenges), something is occurring other than investment. Provided the fund promoter understands this and communicates it clearly to investors, both parties are free to pursue the strategy. Yet just as some investment strategies are ill-suited to traditional fund structures, some investors lack sufficient experience to spot the alloy and its hazards.

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Table 2 *continued*

Design Feature	Issue	Remedial Strategies
	Indifference curve analysis shows that resource allocation decisions entail complex trade-offs between quantitative and qualitative factors. Some are clear; others are subjective, even unwitting. Yet the impact-first-finance-first debate misleadingly posits a choice between degree of financial return and degree of impact. In fact, it posits that commercial viability, from which financial return is derived, can be subjugated to impact objectives. Priorities and values always drive investment decisions. They do not, however, create a choice between a viable and unviable business, or one that will become so. An example illustrates the point. Presented with investment option 1, an oil company, and investment option 2, a solar energy company, many will opt for the latter. Other things being equal, the investor can reasonably expect buoyant demand for solar energy, and impact-related objectives may include anticipated reductions in greenhouse gases associated with the renewable energy option. Option 2 becomes a very different prospect, however, if the fact of its nonextractive production is elevated above the commercial viability of the business. Any business may fail; the sophisticated investor recognizes this fact. However, cloaking investment uncertainty in impact potential is misleading and damaging to the sector. This is not the same as discouraging investment in unproven business models. The expectation here is that the potential financial reward compensates the risk, hence the difference between venture capital and private equity. However, the impact-first-finance-first debate is specious; it is a proxy, even if unintended, for more fundamental challenges facing impact funds, and it alienates sophisticated prospective investors.	The solution is threefold: improved fund manager capacity, better investor education, and clear segmentation of fund offerings. The emergence of venture philanthropy illustrates the point. Venture philanthropy is defined as the application of principles of traditional venture capital financing to philanthropic endeavor. The objective is usually, but not necessarily, to generate profits while achieving positive social impact. It can be described as providing grants and patient capital to small businesses that hopefully will grow. Although some even question this very premise, managers should not be forging fund portfolios of small deals that, even in the venture philanthropy modality, may not survive. Moreover, investors should not be equating them with proven fund strategies. It is not that patient, early-stage capital is not needed, nor that infusing angel/seed finance with social objectives is inherently wrong. On the contrary, enthusiasm for a social thesis should not be allowed to obfuscate the fact that an investor is incurring venture capital risk whether he/she is a patient capital provider or passionate about impact. This is not a debate about whether grants or subsidies should be used. Venture capital was heavily subsidized in the 1950s and 1960s in its birthplace, the United States. The problem is that inordinate focus on a social thesis overshadows commercial imperatives, and in some cases, the long trajectory to viability, if reached, is justified by arguing that business models focused on the poor are difficult to scale or simply take longer. It does not require a growth story like Celtel to debunk this myth. Industry advocates, impact measurement specialists, and think tanks must ensure that they understand the delivery mechanism and medium that they cover by hiring more practitioners. Next, the gamut of products and risk-reward profiles need to be explained to investors. Finally, offerings that do meet mainstream asset owners' fiduciary requirements must be carefully segregated from those that do not. Bluntly expressed, chief investment officers are not sanctioned to entertain impact-first-finance-first debates, and will likely reject the very premise as spurious.

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Table 2 *continued*

Design Feature	Issue	Remedial Strategies
Investment teams	Global interest in impact investing is growing. However, unlike accountancy, law, or medicine, it has no clear career path. It requires a broad skillset, from investment, to fund administration, management, and business operations, to MSME development. The proliferation of impact funds (and social enterprise start-ups) far outstrips the supply of experienced investment executives or entrepreneurs. As a result, team composition has been dangerously skewed toward management consultants, traditional development practitioners, sociologists, and measurement experts, many of whom hail from NGOs, think tanks, or the public sector. Investment banking is a familiar proxy skill on new teams. Other common substitutes for experience are seasoned investment committee members, with assurances that they will provide mentoring. No matter the experience of investment committee members, however, there is no substitute for investment skills on the investment team.	The academic community is taking the lead in preparing people for careers in impact investing. Some of the world's top universities and business schools offer degrees or specializations in social financing. Others offer modules within masters of business administration or masters of public administration diplomas. Academics with practitioner backgrounds should advise students to acquire the requisite investment skills in traditional private equity or adjacent disciplines before pursuing impact investing. To the extent that academic institutions can broaden social financing curricula, with particular focus on investment techniques and financial analysis, this will help relieve human resource bottlenecks. Irrespective of investment strategy, more funds should be rejected on the basis of team composition. By the same token, the DFI and donor communities should explore counterbalancing measures, such as taking stakes in fund managers, secondments, creating starter funds, or incentivizing established managers to develop impact fund lines.
Fund design	The preceding issues are both causes and symptoms of fund design weakness. They reflect excessive focus on the social thesis; insufficient scrutiny of the viability of the investment thesis, irrespective of any social objectives; undetected tensions between financial and social imperatives; a fetish for small transactions, which sit awkwardly in fund structures due to intensity and volume; and exaggerated expectations that small, impactful transactions can quickly go from zero to scale.	Flawed fund design can be prevented by fund structuring experience and investment expertise. New and young teams must be counselled to follow a methodical fund design sequence like the one below: • **Investment thesis.** Establish the fund focus by triangulating the investment opportunities, transaction profiles, and impact thesis. • **Due diligence.** Rigorously test the investment thesis against deal flow. There should be two focus areas: sufficient deals to carry a fund, and opportunities that validate the investment thesis in its entirety (i.e., opportunities in relevant sectors to build/expand commercially viable businesses whose models address the social or environmental challenges identified). • **Fund model.** Construct an indicative fund portfolio composed of as many actual opportunities in the fund pipeline as possible. The purpose of the fund model is to calibrate the average deal size and number of transactions with the

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Table 2 *continued*

Design Feature	Issue	Remedial Strategies
		fund size; specify/modify the likely transaction types and instruments/ structures to be used; based on these, estimate the fund income and reflows, if any (income, interest payments, dividends, royalties, other); and revisit the viability of the original investment thesis, management fee, and operating costs (i.e., the fund profit and loss over the full fund life). • **Sensitivity analysis.** Rigorously scrutinize the fund model against multiple risks: country risk, sector risk (e.g., the effect of disease or import tariffs on an agriculture fund), and currency depreciation. Does the investment thesis allow for course correction by geography, deal size, deal type, investment structure, or a combination thereof? Is the fund economically viable, especially when the management fee declines post-investment period?
Impact measurement	Impact measurement enables learning and holds the industry to account. Many traditional practitioners still question the presence of investment or even the private sector in any development intervention, let alone a profit-making one. Unfortunately, the importance of measurement has become so exaggerated that it is distracting investee companies and managers to the point of jeopardizing them. It seems self-evident that if a business fails, there is nothing to measure other than the size of loss and rate of collapse. The determinants of business success and survival are not impact indicators, but of cash flow, financial discipline, strategic planning, good governance, inventory management, and human resource management. Yet the inexperience of some industry advocates in fund design and capital deployment, and the naïveté of many emerging managers, who were persuaded that impact measurement is among investors' top selection criteria, have obscured the axiom of 'out of business, nothing to measure'.	Impact measurement must be put in perspective. Both investors and managers must take a practical approach to the sequencing and intensity of measurement. The voice of investees must be heard, and their capacity to undertake measurement, monitoring, and evaluation considered. It can take months or years of working with management before the fund manager receives reliable accounts, let alone impact data. Anecdotally, chief financial officers are the senior management members most frequently replaced at fund managers' insistence one or more times during the investment cycle. As informative as baselines and regular impact assessments are in illuminating the evolution of impact, daily operations and financial performance must take precedence. To the extent possible, impact measurement should serve a commercial as well as reporting purpose. When used as a diagnostic tool, it can facilitate understanding of demographic trends, market segmentation, customer retention, customer outreach, and product/service modifications required.

BOP = base of the pyramid, DFI = development finance institution, MDB = multilateral development bank, NGO = nongovernment organization, MSMEs = micro, small, and medium-sized enterprises.

Source: ADB consultant.

Box 9: Voices of Practitioners—A Conversation with Teresa Barger

Teresa Barger was the director for private equity and investment funds at the International Finance Corporation (IFC), among many other positions during her 21-year career there. She is currently chief executive officer of Cartica Capital, which she cofounded in 2008.

Q: When you were building the private equity and investment fund business of the IFC in the 1990s and 2000s, on what aspects of product and manager quality were you focused? What lessons learned apply to the nascent impact and inclusive business (IB) fund universe?

A: When I first started looking at private equity funds in emerging markets in the late 1990s, the biggest issue was that no manager had any real experience. There were virtually no professionals. And there were some charlatans who saw an opportunity to take the money and run. By 2000, one could find one or two "refugees" from developed market private equity getting active in emerging markets, but that was the best we could hope for. The others were repurposed investment bankers or staff who had left development finance institutions (DFIs). Today, the landscape is different. One can get managers who at least have had experience in the asset class in emerging markets. And I have not come across charlatans as in the old days.

The lessons may be that no matter the team, the investor must be convinced that their experience fits their stated strategy, that the organization is fair to all partners so you will not lose a manager to infighting, that this team is really committed to sticking out 10 years and more, and that they are focused first on creating great companies and only secondly on their own remuneration.

Q: Does the premise of impact investing, of which IB is a subset, need to be revisited?

A: There is an assumption that a new type of investor is to be found—the ultimate investor (in other words, not an intermediary) who is explicitly willing to take a lower return to participate in a product that is seen to further social good. This remains a hypothesis in the fund context. Can this disposition really be counted on for the duration of a 10-year private equity fund? The problem is that investors are being sold a bill of goods that says that returns must necessarily be below-market, that returns must be subnormal. Well, if you have a great product and there is a market for it, other things being equal, you are ready to go.

I fundamentally believe that all businesses that create goods and services that people want to buy at a price they want to buy them are doing good in the world—as long as these businesses play by the written and unwritten rules, including being truthful, fair, and caring for their surroundings. Yes, businesses must address negative externalities related to their production. And perhaps there are some endeavors where externalities can never be properly addressed. But I do not believe in the inherent moral superiority of artisanal jute basket production in Malawi over the manufacturing of ball bearings in Kansas.

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Box 9 *continued*

Q: Do you see institutional investors piling into impact offerings over time, as many industry advocates suggest?

A: There is a hypothesis that investors want this product. I am not sure that is the case. It is unproven. Measurement of outputs, outcomes, and impacts, to the extent that this is possible, is needed to build the case. Part of the problem is that very few investors know how to parse out environmental, social, and governance (ESG); impact; and sustainability. If you think of these as three overlapping rings, no one knows what is in the middle. Is that what impact is, the bit in the middle? Is that what is being offered to investors?

I am told that Millennials want to ensure that their investment portfolios reflect their values and that they are keen to buy sustainable investment products. This is not a surprise and comports with what I see among many people in that age group. What is untested is whether they are willing to give up return for impact, and, if so, how sustainable that trade-off is. I would bet that the wave of the future is investment products that claim to be good where no return trade-off is needed. The danger here is that every asset manager starts branding his or her product as sustainable whether it pays attention to ESG or other impact factors or not.

Many of us in the asset management world have tried to be quite strict about understanding when our analysis of E, S, or G factors was relevant for risk mitigation and when it could be used for value enhancement. We spend a lot of resources on ESG analysis because it improves returns and mitigates risks. It is also fine that other people see it as virtuous. But I think of it as just making the corporate world as it should be—sensitive to shareholders, employees, and customers, and concerned with mitigating negative externalities and perhaps enhancing positive externalities. I don't think we deserve a gold star for seeking to enhance returns.

Q: Do you think the traditional fund structure suits impact investment and IB funds that focus on smaller companies?

A: Building companies takes time. A 10-year life does not suit small, young companies (remember we are not in Silicon Valley venture capital mode here). We shouldn't forget that the fund product was not created to meet the needs of young emerging market companies. It was developed in the 1970s to meet the needs of insurance companies. Therefore, because 10 years is not long enough for these companies to reach their potential, you have funds selling to funds selling to funds.

Q: The focus of so many impact investment and IB funds on small companies suggests a perception that there is a correlation between small and impact. Are you comfortable with this premise?

A: There is nothing inherently better or more impact-generative about a small, medium, or large company. The fact is that companies of all sizes are needed. What can be said is that large businesses are able to take advantage of scale economies, and they are more productive than smaller businesses. Hence, one of the issues the private equity investor is solving for is to ramp up productivity growth. That is usually achieved by moving

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Box 9 *continued*

companies from small to medium to large. Now, every business that obeys the law, that is not a monopoly, that is not killing people with its products, will achieve impact of some kind, whether it be through employment, contributing to gross domestic product, paying taxes, and so on. Most businesses also require a supply chain of some kind, which engenders growth in smaller companies.

A helpful way to revisit the question of size is to ask, how did the People's Republic of China become less poor? This was the largest development experiment of our lifetimes, and it was achieved through vast investments in infrastructure and through the output of behemoth organizations. The big question for the People's Republic of China model, therefore, is could this have been done without the enormous costs in pollution, displacement of people, and corruption? But there is no question that hundreds of millions of people were lifted out of poverty by the creation of a corporate "ecology" where large companies were the primary engine of economic development.

Q: How important is corporate governance in realizing contributions to the economy and other positive contributions, which some may call sustainability or others impact?

A: Without good governance, one cannot have a sustainable company. Good governance is required to reinforce the importance of, and commitment to, sustainability. It is beyond question that companies run for the good of shareholders, employees, and customers will perform better. The elusive fourth constituency, on which more work needs to be done, is the stakeholder. One thing that we do know is that value is destroyed when managers run companies for their own benefit at the expense of the other constituencies.

Q: How important are returns in your view?

A: Returns matter. They matter a lot. The reality is that if one is getting a 25% return on invested capital in India, this will attract others who will do the same thing. Investment will be crowded in. Business models will be adapted. Clusters will form. And poor people will become less poor. So, the notion that one can achieve impact without returns on capital is suspect. How can a business model be sustainable if it is not financially sustainable? I understand there are exceptions when grants can support an enterprise that funders want to exist. The publication *National Geographic*, before the profitable parts of it were sold to a media tycoon, may have been a good example. And Grameen Bank went on for years with zero return on equity. But then one must have sustainable charitable funders. I suspect that the universe of philanthropy-supported companies is bound to be small over time.

Pooled investment vehicles, such as private equity funds, have a critical role to play in providing finance to IB. They are beset by two current challenges, however. First, despite decades of evidence that they are ill-suited to small, early-stage transactions, they remain the modality of choice for most impact and IB-focused fund managers. Second, and in consequence, crowded out of the narrative reaching mainstream investors is the fact that funds targeting larger, expansion-financing transactions not only have greater prospects for achieving inclusion and impact at scale, but are more likely offerings to suit institutional capital. The limitations of

the fund modality for seeding and stimulating small businesses must be noted as well as the unrealistic impact expectations that have been heaped on them. This requires boldness, for it goes against the grain of some early fund managers and industry networks, which have invested much in the small-is-developmental narrative. As the invitational contribution below demonstrates from a leading practitioner who helped build the emerging markets private equity industry in the 1990s and 2000s, interrogating these tropes sheds light on the fundamental building blocks that determine whether a fund will succeed.

C. Optimizing Inclusive Business Fund Design and Management

The evolution from MSME funds to impact and IB funds has been traced above, highlighting salient design and management issues. If it is acknowledged that infusing social objectives into funds—although well intentioned—introduces a mutation, two paths emerge. Either funds can be discarded as an IB investment strategy, or the mutations can be mitigated to the greatest extent possible with the tools available including fund design, the investment process, manager–investee engagement, and manager–investor engagement. The following section examines five foundational guidelines that marry the apparatus with ambition (i.e., the fund modality with the IB thesis). Thereafter, it profiles the approach of an IB fund in Southeast Asia that used these tools during its design process and is now in its second year of operation. It is an example of best practice in impact fund design.

1. Foundational Design and Implementation Guidelines

The following guidelines, based on more than 20 fund designs across Africa, Asia, and Latin America, are critical for effective impact and IB funds creation.

Define inclusive business with confidence. IB has inherited many meanings. Labeling an impact fund as IB implies that inclusion will feature in various areas of fund design, such as the business model, sector focus, and social thesis. Yet what characteristics should be sought, and how can the degree of "IB-ness," or the IB quotient, of an investment strategy be determined? Because IB fund management is in early adolescence, it is for the designer to determine and the investor to accept. The following features are important when determining an IB quotient.

(i) **Geography.** In Asia, Bhutan, Myanmar, and Nepal have, until recently, had little or no risk capital. India's least-industrialized states were often overlooked as well. Western provinces in the PRC received a fraction of the private equity investment focused on the eastern seaboard. Thus, a fund manager may define IB as including one of these countries or regions in an investment strategy. For some investors, this may be inclusive enough. The argument could be that MSME investment in such poor regions is necessarily inclusive. For other investors, geography alone may be too vague a criterion. The salient point is that for some, this may count. Others may quip that without meeting the criteria outlined in Section I, such strategies do not count as IB or even impact funds in the broadest sense. Once again, impact and inclusion are in the eye of the beholder.

(ii) **Sector or thematic focus.** Women-owned businesses, minority-owned businesses, agriculture, health care, sanitation, housing, and clean energy are some sectors and themes in the IB fund landscape. Yet investors must carefully assess the credibility of the IB quotient. For example, by health care, investors do not anticipate a portfolio of high-end ashrams in India or luxury spas in Thailand; they likely anticipate rural maternity clinics or health centers. Proposed IB strategies also need to be supported by additional IB drivers. For example, a women-owned business in Central Asia could seek to compensate for local dynamics that marginalize female entrepreneurs and impede access to financing. However, supplementary guidelines may be required to specify beneficiaries by income levels or geography to assure investors that the fund will not back, for example, wealthy elites or daughters of oligarchs simply because they are female.

(iii) **Transaction size or type.** Some funds focus on small businesses and early-stage investments because they are particularly vulnerable to exclusion by formal financial institutions and equity investors. Access to capital becomes the main IB driver in this instance. The IB justification leads with a transaction type, size, and market segment, underpinned by sector selection and poverty incidence.

The point about these inclusion levers is that IB quotients cannot be quantified or scientifically determined. Instinct and common sense must prevail. It is for the aspiring manager to make the case for the credibility of the IB thesis, its "IB-ness," and the suitability of a fund structure to it. It is for the investor to judge.

Question the correlation between inclusion and deal size. There is no positive correlation between small, early-stage deals and impact, apart from their higher risk profile. Few impact or IB offerings target expansions, management buy-ins, or consolidation opportunities in the $2 million to $10 million range, although their inclusion potential through sustained value chain stimulation and demand generation may be greater. Yet many in the IB community are wary of such strategies. They fear fund managers disguising traditional strategies as IB offerings in challenging fundraising climates, as well as the conditioning of investors to associate IB with small deals or CSR initiatives. If managers are methodical about fund design, remain mindful of fund arithmetic, and ensure that inclusion is anchored in the commercial viability of deals, they need not be bound by industry bias or IB profiling.

Embed inclusion into the investment process. There are dangers in defining the impact–finance relationship as not mutually reinforcing, as this de-emphasizes the need to embed impact into key stages of the investment process. More than evaluative criteria are needed to guide deal screening and due diligence. It means creating tools and training investment teams to assess every deal's commercial route to inclusion and/or IB growth trajectory. During portfolio management, it means supporting investees' IB strategies just as one would strengthen a management information system.

Focus on transformational change. IB strategies infer business models that resolve obstacles faced by the poor; thus, they demand transformational change. Yet this does not require new technology, nor that the rules of the game must be rewritten for an entire industry. Rather, it means successfully addressing an aspect of the poverty penalty, or that a pain point such as price, affordability, availability, or opportunity has been ameliorated or removed. Companies are a suitable delivery mechanism for such objectives, because they are not established for defined periods. Owners and managers wish them to grow, so there is natural common

ground between impact drivers and commercial imperatives. Demonstrating this to investors, and anchoring it in a well-presented fund pipeline, is critical.

Eschew social impact targets. Adding social impact targets to remuneration structures in some funds has been an especially hazardous development in the field. The rationale is understandable—social impact targets will maintain manager focus, avert mission drift, and incent impact maximization. The effects, however, can be disastrous. How can impact be calculated ex ante? How much impact is enough? What makes one deal more impactful than another? Is such impact to be evaluated on a deal-by-deal or portfolio basis? Is it acceptable if one particularly impactful investment compensates for another that is less so? Will targets skew investment selection? If impact is below target, but there are mitigating circumstances, does that count? Further, moral dilemmas arise. Does the manager sacrifice an investee, or the entire portfolio, in pursuit of impact? Should an investment be kept on life support (i.e., additional capital infusions or grants) in the interests of impact even when its commercial prospects are poor? How can the purity of motive be ensured if impact is incentivized through carried interest or bonuses? How can managers be prevented from gaming the system?

Managers and investors are equally culpable when impact targets are used. Managers may hope that targets translate into capital commitments, while investors may impose them to keep managers honest or to separate the wheat from the chaff. When DFIs and foundations issue requests for proposals for impact and IB strategies, they often see volunteering targets by managers as a sign of commitment. Yet impact targets cannot be scientifically set; their attainment cannot be objectively evaluated; and as instruments, targets are unfit for purpose. Provided that the impact thesis is borne out by the deal flow and that the investment policy circumscribes the transaction universe, an investor's commitment to a fund should be viewed and honored by both investor and manager as entry into an 'impact contract'. After all, why should manager removal provisions in fund shareholders agreements not apply to transgressions in the impact domain as much as any other?

2. Role of Technical Assistance

By the mid-2000s, TA had become a familiar tool for funding the nonfinancial support needed by emerging market MSMEs. TA facilities can be a proxy for the additional annual management fee that impact funds need, although this is not an ideal way to address the shortfall. Most TA funding is directed to portfolio companies; in some cases, it can be used to build fund manager capacity as well. In exceptional cases, it can be used for capital expenditure that both fund managers and investees are obliged to make by shareholder agreements (e.g., to achieve environmental compliance) but that are unaffordable.[29]

When used prudently, TA is a constructive tool. In the IB context, it is especially helpful for optimizing business models. Hazards also exist. It can become a subsidy and a crutch, extend the lives of unviable businesses, mask poor investee or fund manager performance, and be misdirected and abused. This subsection explores the salient issues relating to TA use in support of IB funds based on the experiences of fund managers in Asia and beyond. It suggests preventative measures to avoid design pitfalls and to ensure the healthy use of TA.

[29] DFIs and MFIs, after much debate, came to see that an MSME cannot be expected to spend money on an environmental, social, or governance (ESG) improvement that brings it into compliance with national or international standards but bankrupts the company in the process.

Pre-investment technical assistance. Using TA pre-investment is precarious. To the experienced investor, it raises doubts about the viability of the investment thesis, specifically, whether the deal pipeline as presented during fundraising is sufficiently robust. It can also raise questions about the quality of the fund manager. If a justification is made that TA is needed to make an investment viable, proceed with caution. This can be a sign that an inexperienced fund manager has allowed the impact thesis to obscure the true state of the target businesses. This may have occurred unwittingly, but it can be a symptom of a deeper issue. Especially in impact funds targeting start-ups, early-stage, and/or small investments (i.e., $500,000), theory may be meeting practice.

Risk mitigation measures for pre-investment TA include the following:

(i) **Set high conversion rates.** Set a maximum number of prospective deals for which TA can be used, based on a cumulative conversion rate. For example, if after two pre-investment TA interventions neither deal is closed, the TA committee reassesses any pre-investment TA use. It may temporarily suspend it or require committee approval on a case-by-case basis.
(ii) **Restrict usage.** Ensure that pre-investment TA can only be used for a small number of activities, such as targeted business development services in one or two areas for a short period; an urgent environmental, social, or governance (ESG) intervention; or a defined market study or customer segmentation exercise.
(iii) **Use prudential limits.** Restrict pre-investment TA as a proportion of the proposed investment size to a prudential amount (e.g., no more than 10%).
(iv) **Ensure there is skin in the game.** Seek financial contributions from the target company, no matter how small, for the intervention(s).

Many young fund managers are unaware that pre-investment TA can be damaging to the house, that it may acquire a reputation for providing handouts. If the investment rate is slow, it may become known for "spray and pray" (i.e., doling out pre-investment TA to surface viable deals). It may cause inefficiencies as unsuitable companies approach the fund in search of TA.

Post-investment technical assistance. Most donors, DFIs, and investors are more comfortable with post-investment TA. Many pre-investment policies apply to post-investment TA, especially regarding usage. Permissible activities generally include business development services, training, sector expertise, ESG system implementation and training, business professionalization, and market studies. Two activities should be handled with caution, however:

(i) **Secondments.** These can help inject expertise over a sustained but defined period and avoid the vacuum that can follow a consultancy, in which no one is on hand to systematize new techniques or processes. The danger is that secondments can morph into longer-term positions, effectively subsidizing fund costs and obscuring skill shortages in investees that need to be addressed.
(ii) **Impact assessment.** Few investees, especially small, young businesses, have impact assessment expertise. Monitoring and evaluation strategies and impact-related data collection are unfamiliar, and producing accurate financials can be difficult. The disproportionate emphasis on impact measurement, especially early in the deal cycle, often swells TA budgets for impact assessment. It is often among the easiest activities to get through during TA committee meetings. Responsible TA committee members, however, must ensure that impact measurement is introduced at a point

Box 10: When the Need for Technical Assistance Is a Symptom of a Deeper Problem

The author of this report was mandated to assess a prospective technical assistance (TA) facility underpinning an early-stage impact fund in India in 2015. One deal in the pipeline was in the education sector, a consolidation of struggling schools for lower-income children, the thesis being that economies of scale via a monitoring and assessment strategy would lead to efficiency gains and create a viable business model.

When asked how a TA facility may help, the management team identified the following key area: "We need to learn finance and hire someone who knows about acquisitions. We don't know anything about finance."

What can be learned from this admission?

- The management team of a deal in the fund pipeline lacks the critical skills to execute its own business plan.
- The fund manager is looking at a deal whose impact story has clouded its assessment of management.
- Equally as worrying is the due diligence of the fund-of-funds manager on the fund manager, because if the fund pipeline is this precarious, what does that suggest about the rest of the deals in it? What does it imply about the skills mix within the fund-of-funds manager and the rest of the funds in the pipeline of its fund of funds?

Source: Author's view.

when investees have the resources, it does not interfere with day-to-day business activities, and it does not displace TA expenditure on other priorities.

Management of the technical assistance facility. There are two options for TA management: in-house or outsourcing. The suitability of either depends on fund manager capacity and the robustness of governance.

(i) **In-house.** The advantage of keeping TA in-house is that TA can be synchronized with the deal cycle. Transaction and TA-related key performance indicators can be monitored concurrently, and disbursements can be coordinated (e.g., if a company is performing poorly or its survival is in question, TA disbursements can be paused). The danger of in-house management centers around transparency and accountability. Executives can come under pressure, so management must ensure the autonomy of the TA team. Appointing external members to a TA committee can be helpful.

(ii) **Outsourcing.** While avoiding awkward internal dynamics, outsourcing also has challenges. Coordination between the fund manager and TA manager can be confusing to investees and slow decision making. Lack of financial expertise can cause them to question appropriate TA proposals. Moral hazard is also a danger; if remuneration is linked to TA deployment and administration, then the TA manager can be incentivized to create work. Lastly, outsourcing is only as good as the relationship between the fund manager and TA manager. If this deteriorates, the fund's portfolio companies suffer.

On balance, in-house TA management is preferable, provided that the fund manager is reasonably experienced. For a first-time fund manager, handling TA in house is likely to be burdensome. The risk of mismanagement may be higher. The outsourced model, however, is generally costly and slower, and the three-way dialogue that it requires between fund manager, investees, and TA manager can cause confusion and conflict.

Exclusions. Drawing up a list of clear exclusions for TA use is essential. Most TA facilities forbid capital expenditure to avoid subsidies and corruption, such as onselling. In rare instances when TA is allowed to cover management costs, it is limited to implementation of TA-supported activities, which can lead to conflict among TA funders, investors, and the manager, as it is impossible to equitably parse out the percentage of manager engagement chargeable to the management fee and TA facility. Staff costs are never covered by TA other than through time-bound secondments.

The presence of TA in support of IB funds is, in some ways, a double-edged sword. In one respect, it is easily justified. Business models that engage with lower-income groups in developing economies are challenging. Training, expertise, research, and technology transfer are needed in the developing world, and TA is a convenient way of covering these costs. Yet if it is argued that BOP markets, as repositories of latent demand and purchasing power, present compelling commercial opportunities, IB funds should graduate from needing TA. Still, some private and institutional investors cannot reconcile the use of TA in a commercial offering. For them, it renders a fund subcommercial. The onus is thus on IB fund managers to show that the commerciality of their funds is not compromised by using TA. In this regard, the fund community should clearly distinguish between early-stage, higher-risk offerings that rely significantly on TA from more mature offerings, like the Asia Impact Investment Fund, which have no TA funding.

3. Case Study: The Asia Impact Investment Fund

This case study illustrates a firm yet flexible approach to embedding impact into a fund thesis. Unlike Africa, India, or Latin America, the fund promoters noted the lack of dedicated, institutional-grade impact fund management capability in Southeast Asia and the PRC, let alone IB-focused capability, signaling a compelling commercial opportunity and first-mover advantage. The fund promoters had seen the proliferation of small impact funds (i.e., $15 million–$25 million), especially in the Greater Mekong Subregion, but spotted their unsuitability to attracting private sector investors, especially high net worth individual clients for a first foray into impact investing. Moreover, they noted that such funds generally targeted small, early-stage transactions, an orientation in countries and areas with little history of MSME private equity that seemed not only risky but oblivious to the region's socioeconomic profile. Thus, lower-middle market opportunities emerged as the appropriate deal type for the fund, especially because high net-worth individual clients, although enthusiastic about the product, were cautious and risk-averse.

From the early 2010s, Credit Suisse in Singapore and UOB Venture Management Private Limited (UOBVM)[30] received inquiries about impact investment from high net worth

[30] Credit Suisse comprises two entities in Singapore: Credit Suisse AG, Singapore Branch and Credit Suisse (Singapore) Ltd. Both are part of the global commercial and investment bank, the Credit Suisse Group. UOBVM is a subsidiary of United Overseas Bank Limited (UOB), a commercial bank focused on Asia with headquarters in Singapore.

individual clients in their wealth management platforms. With more than 1 decade of experience in microfinance, and structuring products for the education and environmental conservation sectors, Credit Suisse began to explore the feasibility of a fund product. Meanwhile, UOBVM, with decades-long experience in MSME private equity and arguably the strongest track record in Southeast Asia, was also intrigued by an impact fund opportunity but lacked the impact expertise. Thus, Credit Suisse and UOBVM joined forces to design an impact fund focusing on the PRC and selected Association of Southeast Asian Nations (ASEAN) members.

The Asia Impact Investment Fund was launched in March 2016 with capital commitments of $56.5 million. It is managed by UOBVM and advised by Credit Suisse on matters related to impact. The fund makes average investments of $1 million–$8 million, including follow-on tranches, and targets rapidly growing private companies in Cambodia, the PRC, Indonesia, the Lao People's Democratic Republic, Myanmar, the Philippines, Thailand, and Viet Nam. As of November 2017, the fund has committed $18.6 million to seven transactions in Cambodia, the PRC, Indonesia, Myanmar, and Viet Nam. The following design features are significant:

(i) **The investment policy is impact-driven.** The fund's impact policy could be interpreted as a negative screening tool. By being explicit about the sectors and, critically, subsectors to be targeted, however, investors and the fund manager are clear as to what will populate the portfolio.
(ii) **Sectors and business models are considered concurrently.** Transaction eligibility is a function of both the sector and business model. In the investment committee, why this business model is within this sector and how it delivers transformational change are always questioned.
(iii) **The focus is on commercial impact drivers.** In addition to the business model and sector, the fund impact policy forces the investment team to identify the elements of the business—day-to-day operations and strategy—that drive impact.
(iv) **There is no technical assistance.** This sends a signal to the market that IB deals in Southeast Asia need not be treated differently than others.

Most high net worth individual clients in Credit Suisse's wealth management platform did not have a precise idea of what an impact fund looks like. Neither were institutional investors or family offices inflexible. All envisaged a portfolio of companies that would address social challenges with commercially viable solutions. Poverty reduction was also a goal, but beyond these, Credit Suisse and UOBVM had complete creative license. They began by outlining the fundamental characteristics that the fund may have:

(i) A **commercial approach** to maximizing social impact, supported by the conviction that commercial viability is the guardian of both business sustainability and impact.
(ii) An **impact strategy** centered on business models and sectors. The business model centers on investing in commercial strategies that address issues of access, affordability, quality, availability, and/or choice of key goods and services for lower-income groups; or incorporates lower-income groups into the supply chain as producers, distributors, and/or employees in ways that increase their incomes and improve their livelihoods. It targets sectors most likely to generate positive impacts for lower-income groups, including agriculture, health care, education, housing, sanitation, water, transport, clean energy, and financial services.

(iii) A clear definition of the **target demographic** as people living at the BOP on $3,000 per year or less.
(iv) A concentration on **expansion financing**, given the scarcity of risk available to MSMEs regionwide, especially in the under $10 million range, and consequent attractive valuations.
(v) From a risk mitigation and cash-flow management perspective, **use of a range of debt and equity instruments**, generally taking minority stakes with board representation (or observer status) and the right to participate in management decision making.
(vi) A broad yet circumscribed **investment policy** to provide sufficient deal flow and diversification, and to reflect that, in general, only 1–2 deals of every 75–100 considered are done, and to ensure that investors have a portfolio that performed as promised by the fund.

More importantly, the fund should target a minimum gross IRR to investors of 20% per year in United States dollar terms (likely a net return of 12%–15%). To the extent that the target can be exceeded, the fund team should make every effort to do so. Two features are noteworthy in this context. First, although fund executives believe that a higher return is possible, they were cognizant during fund design that exaggerated return projections served no stakeholder interests. The fund also deliberately eschewed grant funding and concessional instruments, such as guarantees, first-loss capital, and TA, because both institutions believe that to attract large capital flows into impact offerings in the long term, their commercial merits must be demonstrated unaided. Credit Suisse, which took the lead on fund raising, marketed the fund to clients as it would any other product.

Above all, Credit Suisse and UOBVM were explicit about their shared definition of impact investment. To cite the private placement memorandum of the fund, it was considered "to be an impact investment fund, defined as a strategy which generates positive social and, in some cases, environmental benefits, as a driver of, and alongside, financial returns." Further, the document stressed that these outcomes were not viewed as "by-products or 'incidentals' associated with Fund investments; rather, as the means to which company growth and profitability are the ends. In this sense, the...definition of impact investment considers financial performance and impact realization as mutually reinforcing."

Finally, during extensive due diligence, Credit Suisse and UOBVM triangulated the characteristics of the target region with intended investment types and sizes and the impact thesis, from which a pipeline of investment opportunities was constructed. The following conclusions led the partners to proceed:

(i) The fund's impact investment thesis was timely because the demand for goods and services from lower-income groups was vastly underattended and sufficiently robust. The investment strategy could carry the fund's social and financial objectives.
(ii) SMEs were strategically positioned to benefit from this, and there was a compelling role for risk capital to finance them, because they were generally shunned by risk-averse formal financial institutions.
(iii) Governments in the region were increasingly recognizing that the private sector is a critical partner in addressing growing demand for basic goods and services at the BOP.
(iv) The lack of private equity investors in the region focused on lower-middle market companies pursuing consumer- or producer-focused BOP engagement strategies.

The only reason that the product was labeled an impact rather than an IB fund was that impact investment is a nascent discipline in the region, and IB, a subset of impact investment, is less familiar.

The Asia Impact Investment Fund draws a distinction between impact investing—defined as a strategy that deliberately generates positive social and/or environmental benefits as a means of, and alongside, achieving financial returns—and other related strategies. This differentiates the fund from two approaches often presented as impact strategies but that are, more accurately, components of it. The first is the application of ESG standards to investment selection. Credit Suisse and UOBVM take the view that robust ESG policies, sustainable resource use, and minimization of environmental degradation on one hand, and support of investees to achieve compliance with ESG standards on the other, are basic building blocks of impact investment. The second is socially responsible investment, defined by the European Sustainable Investment Forum as "ethical investments, sustainable investments or any other investment process that includes an explicit written policy that applies ESG criteria."[31]

After several months, the contours of a fund came into focus. The partners sought companies pursuing commercial solutions to various social BOP challenges. The framework was used to determine appropriate investment sectors; embrace cross-cutting impact opportunities, such as access to financing; and incorporate inclusion drivers, such as community development and engagement, employment generation, improved access to information, and increased income and productivity. In addition, investments were sought in which technology could be applied to improve BOP-orientated goods and services and their distribution, or to reduce disparities in living standards. Lastly, given that agriculture accounts for a vast proportion of lower-income, rural livelihoods throughout Asia, it was agreed that agriculture should be a central focus. In this way, the fund would address multiple socioeconomic, productive, and even environmental challenges.

With the foregoing in mind, the fund's main target sectors are identified in Table 3. They are not presented as an anodyne list; rather, they are an example of how target sectors and subsectors can be outlined in detail so that investors and the investment team have an unambiguous picture of transactions that will constitute the fund portfolio.

Having identified the BOP focus and sector focus, the Asia Impact Investment Fund then identified several structural and systemic weaknesses to address, such as:

(i) **Supply chain strengthening.** Building mutually reinforcing relationships among producers, processers, aggregators, and buyers to address quality and consistency issues that dislocate supply chains and impede income growth for the poor, as well as the companies themselves.
(ii) **Last-mile solutions.** Extending infrastructure, utilities, communications, information technology, and associated goods and services to rural, remote, or disadvantaged communities through profitable business models.
(iii) **Basic service provision.** Making basic services such as education, health care, housing, and social protection accessible to lower-income groups.
(iv) **Value addition and value capture.** Particularly in less developed countries such as Cambodia, the Lao People's Democratic Republic, Myanmar, and Viet Nam, moving

[31] Eurosif. https://www.eurosif.org/

Table 3: Asia Impact Investment Fund: Sectors and Subsectors Eligible for Investment

Sector	General Focus	Subsector
Agriculture	Agriculture accounts for a vast proportion of economic activity in Asia. In many rural areas, rudimentary production techniques, inadequate access to inputs, and lack of access to financing severely hamper agricultural output. There is also enormous scope to increase local value capture by moving beyond primary production and/or moving up the value chain. The fund targets seven segments of agriculture believed to be especially conducive to IB.	**Agro-processing.** Food production with produce or semi-processed inputs sourced from low-income farmers or fishers as well as investments in agro-processing plants that involve refurbishing or constructing modern plants and introducing mechanized production, hardware, and modern machinery. **Food production.** Food purchases comprise a significant proportion of BOP household incomes. Investment opportunities in food companies producing quality products at price points affordable to lower-income groups. **Primary production.** Increasing yields by facilitating access to vital inputs such as seeds and fertilizers; applying best practices and technology; diversifying crop offerings; improving access to secondary and tertiary irrigation systems; and introducing quality assurance and traceability mechanisms. **Agricultural infrastructure.** Distribution, logistics, storage and warehousing, and development of cold chains. **Agricultural inputs.** Production and wholesale of soil, fertilizer, pesticides, herbicides, tools, tractors, and other vehicles and machinery. **Aquaculture.** Primary production and processing of seafood, shellfish, fish sauces, and pastes consumed throughout the region and beyond. **Niche and high-value products.** Including floriculture, spices, balms, essences, oils, traditional remedies, organic tea and coffee, and specialty vegetables.
Health care	There is burgeoning demand for basic health care services and improved delivery in the region. In addition, as the public sector struggles to meet demand, private companies can play a greater role in developing sustainable commercial solutions to BOP health care needs. Seven health care segments stand out.	**Service providers.** Hospitals, clinics, midwiferies, and diagnostic centers, with a view to improving cost structures, broadening geographical coverage, and introducing new procedures and better standards of care. **Distribution and retail.** Targeting inefficient supply chains or boosting domestic supply to reduce import costs of pharmaceuticals and hospital supplies such as syringes, condoms, malaria nets, and saline. **Light manufacturing.** Increasing domestic capacity where there are cost advantages from unit cost savings and market proximity in pharmaceuticals, medical devices, medical furniture, and equipment. **Pooled health care products.** Developing products that accommodate consumers' cash-flow fluctuations and broadening distribution platforms with partner banks focused on health insurance and employee, family, and community vulnerability schemes. **Medical education.** Entry or continuing education for health care professionals in nursing, midwifery, telemedicine, and distance learning, introducing cost-cutting technology where possible. **Application of medical technology.** Application of technological advances to facilitate provision of new health care services and development

continued on next page

Table 3 *continued*

Sector	General Focus	Subsector
		of business models that improve efficiency and standards of health care provision. **Nutritious foods and clean water.** Protein-enriched and other high-nutrient foods and clean bottled water, where it can be demonstrated that lower-income groups account for a significant proportion of consumers. In addition, emergency food and beverage manufactures, such as Unimix and clean water sachets.
Education	Like health care, BOP demand for education is rising steadily, generating investment opportunities two key areas.	**Primary, secondary, and tertiary education.** Especially models that accommodate limited discretionary income at the BOP by managing costs through student volume optimization and/or franchises. **Adult and professional education.** Including a focus on vocational services where financial, transport, and time constraints of the BOP are accommodated through flexible timetables, classroom locations, or e-learning.
Access to financing	SMEs across the region struggle to access financing due to collateral constraints; fear of approaching formal financial institutions, which often view them as inordinately risky; and familiarity with informal and often punitively expensive lenders. As a result, in cash-dependent economies, particularly beyond urban centers, vast demographic and productive segments remain underbanked or unbanked. The fund therefore seeks the following opportunities in financial institutions and microfinance institutions.	**Microfinance.** Specifically, financial institutions seeking to introduce/expand products designed to reduce vulnerability of livelihoods, such as microhealth insurance products, or to promote inclusion of marginalized groups such as female or microentrepreneurs with little or no traditional collateral. **Microcredit.** Working capital facilities, microleasing, and other products focused on increasing capacity in productive sectors such as agriculture and manufacturing so that small-scale, especially rural entrepreneurs, can participate more effectively in local and regional supply chains. **Agricultural financing.** Products tailored to increasing yields and addressing bottlenecks in agricultural production, including crop and disaster insurance, commodity and warehouse financing, factoring, and reverse factoring. **Other financial services.** Business and consumer financing focused on low- and lower-middle-income groups, including mobile, rural and telebanking, and mobile-enabled agriculture and health care services.
Clean and renewable energy	Including waste-to-energy, biogas, solar, and small hydro companies, and, in some cases, aggregators rolling up such opportunities across communities. Additionally, a focus on community-based or localized clean energy provision with community development and income-generating opportunities from surplus energy production. Finally, linking of clean energy investments and products, especially in the solar sector, to provision of clean water and irrigation, heating, lighting, cooking facilities, and device-recharging stations (e.g., mobile phones and radios).	
Affordable housing	Including construction, provision, and leasing of construction equipment to home builders.	
Logistics and distribution	In many parts of the region, transport and communications infrastructure is not well developed. Distribution networks serving the poor, especially in rural areas, are often inefficient or nonexistent, dampening economic growth. The fund also considers technology-enabled distribution models and logistics focused on lowering distribution costs and/or increasing efficiency of delivery.	
Sanitation, water, and waste management	Water distribution and management; wastewater management in urban, peri-urban, and rural areas; irrigation, mostly secondary and tertiary, in rural areas; as well as general investments in pollution-prevention products or services and household waste management.	

BOP = base of the pyramid, IB = inclusive business, MSMEs = micro, small, and medium-sized enterprises.

Source: Impact Policy, Asia Impact Investment Fund ILP.

up the value chain to capture and retain more economic benefit locally, thereby increasing local incomes, market share, and competitiveness.

(v) **Inclusion of microentrepreneurs.** Scaling portfolio companies' business models in ways that utilize and develop the expertise, local knowledge, and productive capacity of microentrepreneurs; smallholder farmers; and, in some cases, economic actors in the semiformal, informal, and noncash economies.

(vi) **Business formalization.** Professionalizing and improving management capacity and corporate governance so that a cadre of well-managed, well-governed businesses continues to grow after the fund exits portfolio companies.

(vii) **Reduced income volatility.** Smoothing income flows for poor producers, especially in the agricultural sector, by helping them form cooperatives and associations and strengthen their relationships with buyers.

(viii) **Social inclusion and gender balance.** Where possible and appropriate (i.e., where commercially viable and value-accretive), developing company growth strategies that promote inclusion of vulnerable groups, such as youth and female entrepreneurs.

The fund also designed an impact policy to anchor the IB thesis in the investment process and transparently demonstrate to investors how this would be done. The fund's impact policy contains impact-related criteria and methodologies to source, evaluate, select, execute, add value to, and exit portfolio companies. It ensures that the fund's IB-centric definition of impact informs all aspects of its daily investment activities. The salient features of the impact policy are highlighted below:

(i) **Transaction selection and screening.** An investment eligibility test considers three key criteria—sector, IB objectives, and impact alignment. Impact alignment looks for various characteristics, including clear and well-defined commercial routes to impact; robust financial returns predicated on the route to impact; alignment of the impact thesis between the fund and portfolio company; processes in place to develop, manage, and measure societal impacts and engagement; discernible capacity of the portfolio company's goods or services for livelihood improvement through positive impacts on health, physical and mental well-being, disease management or prevention, access to education and information, and food security; opportunity to engage productively in the economy; reduced vulnerability to exogenous shocks such as crop failure; gender equality and empowerment; and models that have a wider transformational impact beyond the portfolio company.

(ii) **Due diligence.** Recognizing that smaller, social enterprises have struggled, due diligence is focused on prospects for growth and profitability, achieving efficiency gains, innovation, and monitoring and evaluation.

(iii) **Prospects for growth and profitability.** This focuses on how the company seeks to capture the BOP market share, and build consumer demand and loyalty. What customer outreach models will be developed and how may business models be scaled or replicated? Does the company have a viable cross-subsidization model, whereby it is able to afford the greater investment and resources required to develop BOP incumbents by serving other market segments? Is the cross-subsidization model viable with a view to phase out the need for cross-subsidy over time?

(iv) **Achieving efficiency gains.** How can the company boost productivity and efficiency, for example, by engaging more effectively and working with its supply chain, improving access to markets for its products, or utilizing and developing labor more effectively?

(v) **Innovation.** Can the business build consumer demand (or demand in the supply chain for its products) through innovation around access and price?
(vi) **Monitoring and evaluation.** What is the company's strategy for monitoring and evaluating product uptake, market trends, changing consumer needs and tastes, and competitive positioning within BOP markets? How will it adjust its strategy accordingly?

Portfolio monitoring and value addition. The fund's investment strategy requires deep engagement with investee companies beyond financial and commercial stewardship and participation on the board of directors or other committees. As such, the fund engages with portfolio company management to support the implementation of commercial, IB-orientated growth strategies. The fund team comprises Credit Suisse professionals with experience in BOP engagement and IB, who advise portfolio companies on BOP consumer engagement and supporting social sector analysis; supply chain development and management; market diagnostics, branding, product development, and marketing; business development services; monitoring and evaluation and development impact assessment; ESG, with a particular focus on employee development, labor standards, and corporate governance; and BOP producer-focused access to financing strategies.

With the above principles in mind, the fund assesses impact at three interconnected levels:

(i) **Individual and societal.** This is portfolio company evaluation from the perspective of individuals, focused on job creation, quality of employment, mobility, opportunity, security, empowerment, and gender considerations; as well as from the perspective of families and wider stakeholders, such as patients, communities, end-users of goods and services, customers, employees, employers, public sector providers, and local governments. Assessment of the societal impact of the fund focuses on the extent to which interaction with portfolio companies at all levels improves lives.
(ii) **Company.** The commercial sustainability of portfolio companies is evaluated, entailing not only profitability at the most basic level but also viability beyond exit. This entails an assessment of changes in headline dimensions of commercial performance, including robustness of BOP engagement models, financial management, management information systems, human resources management, management capacity, corporate governance, health and safety, and environmental performance.
(iii) **Market.** The broader impact of the fund are assessed, including effects on output; consumption of goods and services; net fiscal contributions; export generation; investment mobilization; multiplier effects; and externalities, positive or negative, in terms of access, choice, quality, and demonstration effects on other producers and other sources of financing, capital markets (in cases of listings), and domestic and international investors.

The fund benefits from an impact advisory council, composed of experts in MSME investment, impact investing, and BOP engagement within and beyond Asia. The council works closely with Credit Suisse and UOBVM professionals and the fund to advise on all impact-related aspects of the investment process. More specifically, it opines on the relevance and viability of portfolio companies' BOP-orientated growth strategies, proposing modifications or alternatives where suitable. It is also available to consult with team members in the event that the impact thesis of prospective transactions is unclear.

Although fund investees cannot be named or discussed due to disclosure restrictions, early indications are that the shared vision of Credit Suisse and UOBVM—that the region provides financially attractive investments generating impact through inclusion—are being borne out by the portfolio. In the words of Kian Wee Seah, managing director and chief executive officer of UOBVM, "There is such an important and compelling opportunity to demonstrate that finance is a tool for societal improvement. As the world grapples with the economic and social consequences of inequality, we are committed to mobilizing risk capital to tackle it at the grassroots level, and to offer it as a mainstream investment product."[32]

This case study profiles how well-defined fund parameters can balance sufficient breadth with sensible boundaries to ensure that the fund manager pursues appropriate transactions. Experience has shown that this is a healthier way to achieve impact than using impact targets. In this way, investors gain clarity, and fund managers can deploy capital unencumbered. The supply of well-defined, well-managed IB funds must now be increased so that demand can be further stimulated and then met.

[32] Information is taken from author's interview in March 2017.

V

The Case for a New Hybrid Inclusive Business Financing Product

A. Underpinning Private Equity Funds with Access-to-Financing Facilities

Sections III and IV have shown that bank debt and private equity funds are important strategies for providing finance to IB, but they have limitations. It has been shown that banks' ability to add value to clients in nonfinancial areas is constrained by loan volumes, cost structures, incentive structures, and staff profiles. Second, there is compelling evidence that private equity may be the wrong strategy for getting capital to small businesses, the S of micro, small, and medium-sized enterprise (MSME) segment, calling into question the viability of many impact and IB funds as currently structured. Third, venture philanthropy remains questionable, regardless of whether it is viewed as an investment tool or a philanthropic intervention. It may best be called a development tool with some private sector features.

(i) By teasing out the IB-related problems that private equity and bank debt are solving and the limitations of each, a provocative question emerges: is there merit in harmonizing the two tools into a hybrid intervention? If it is known that equity investments are extremely challenging in microenterprises or small businesses, but access to finance is critical to achieving producer/supplier inclusion, then a hybrid product could be created with two components:

(ii) A fund that makes equity investments in medium-sized enterprises whose growth is predicated on incorporating suppliers/producers into supply chains.

An access-to-finance facility underpinning the fund that provides working capital to suppliers/producers in a way that is synchronized with the equity investment. Debt providers thus understand that growing demand for supply from borrowers, driven by fund portfolio company growth, enhances repayment prospects.

This two-tiered approach may be an antidote to MSME funds overpopulated with small investments. It channels funding in appropriate forms to appropriate value chain incumbents: debt to the producers/suppliers that require working capital, and equity to medium-sized enterprises that require risk capital. Note that equity is not being deployed to micro or small companies to resolve working capital shortages.

The key point is that equity is not being deployed in microenterprises or small companies to resolve what are, in essence, working capital shortages. This sheds further light on why so many impact investment funds focus on early-stage, small transactions. MSMEs or the missing middle do struggle to access financing; therefore, it is argued that impact funds must

provide it because nobody else will. This is the market failure argument, but this reason may actually be flawed and better served by the following sequence of questions:

(i) What kind of financing do suppliers and value chain incumbents need: working capital or equity?
(ii) Are there existing individuals or micro or small enterprises that, with access to financing and nonfinancial support, could be supplying and producing?
(iii) Is there demand, or could demand be generated, in response to which they can supply or produce?

Following the logic of these three questions does not suggest that all that producers/suppliers need already exist, and the only thing necessary is to match the right kind of financing to their needs and to link them with demand. Rather, whether small funds are addressing a flawed equation with the wrong solution needs to be examined.

In response, value chain-focused private equity funds can thus be created that are underpinned by supplier-focused access-to-finance facilities, achieving the following outcomes:

(i) fixing vehicle-related (i.e., fund) problems by decoupling equity investment from efforts to resolve supplier cash-flow constraints;
(ii) directing debt (i.e., inclusive finance) to suppliers/producers that are responding to concrete sources of demand; and
(iii) building more resilient, inclusive value chains through this disaggregated approach that combines top-down equity and bottom-up producer/supplier financing.

Recent analysis undertaken by the United Nations Development Programme (UNDP) in Mongolia provides useful insights into the viability of this approach. Since mid-2017, the agency has been assessing the prospects for a value chain-focused investment fund in Mongolia that would address social and environmental challenges by creating a private equity fund with a supporting access-to-finance facility. The case study below shows how this approach could succeed where others have failed. There is no question that Mongolia is a frontier market with very particular challenges: enormous geography; a small population of 3 million; and severe, long winters. However, supplier-focused access-to-finance facilities to date have failed, and simply aggregating new ones is pointless. This begs a simple question: could an access-to-finance facility with a demand-driver—a portfolio of equity investments—be the solution?

B. Mongolia Case Study

Mongolia faces economic, social, and environmental issues that are being exacerbated by climate change. Strategies for building climate-resilient livelihoods are needed, as Mongolia's pastureland, which supports centuries-old nomadic livelihoods, is succumbing to desertification. Overgrazing of around 70 million animals (mostly goats, camels, and yaks) on land that has an estimated carrying capacity of 20 million animals is accelerating water depletion, while shifting weather patterns are altering precipitation patterns. Unless livestock and pastureland management are modified, overgrazing will compromise the ecosystem that supports herder/farmer livelihoods. It will also undermine, if not eviscerate, Mongolia's two key nonextractive sectors, cashmere and meat.

Unexpectedly, access to financing is at the core of the problem. Because financial institutions have not developed a proxy for traditional collateral (i.e., fixed assets or dwellings that nomadic herders, naturally, do not have), they will only consider animals as collateral. This creates perverse incentives for herders to increase herd sizes, resulting in overgrazing and poor-quality animals, affecting coat and meat quality.

Since the mid-2000s, MDBs and DFIs have supported the herder/farmer economy in Mongolia with various access-to-finance programs, capacity building of herders, and, in some cases, promotion of herder cooperatization. Success has been limited, however, because of three design flaws:

(i) failure to consider the long-term viability of herder/farmer livelihoods, and their economic endeavor as a whole, in the context of accelerating climate change;
(ii) focus on herder/farmer activity in isolation from the value chains of which they are, or should be, part; and
(iii) absence of equity at the demand-source level (i.e., companies offtaking from herders) and of targeted working capital at the supply level (i.e., herders producing in response to demand).

The UNDP analysis suggests that there is a role for private equity to shape commercial, sustainable strategies to the challenges afflicting Mongolia's rural economy. More important than financing, equity would enable fund managers to engage deeply with investees, thereby altering their relationships with herders/farmers as suppliers. By combining equity with an access-to-finance facility, supply chains could be recalibrated in climate-adaptive and -resilient ways.

The UNDP analysis also posits that Mongolia needs an inclusive value chain approach to investment, which differs from the past initiatives in four ways:

(i) **Demand-driven supplier engagement.** By investing in a portfolio of private companies and helping shape their growth and operating strategies, an IB fund could help investees optimize engagement with suppliers.
(ii) **Demand-responsive value chain development.** As portfolio companies invest in developing the value chain—with financial resources, best practices, knowledge, and technology transfer—and as TA is provided to herders, herder output could gain a focus. It would respond to concrete, reliable demand, binding the demand and supply sides in mutually reinforcing manners. To achieve consistent growth, companies must nurture suppliers and help them resolve their challenges to secure quality products. Suppliers, in turn, would be incentivized to reduce livestock quantity and to increase product quality—a key component of climate adaptation in Mongolia—because of the increased incomes and livelihood security afforded by consistent company orders.
(iii) **Strategic access to financing.** Recognizing the persistent cash-flow shortages of herders/farmers, cooperatives, and MSMEs, targeted access to financing—not necessarily cash, but credit—could be provided with the specific objective of enabling herders/farmers to meet demand with quality product.
(iv) **Strategic technical assistance.** Similarly, targeted TA in key areas—animal husbandry, veterinary services, food safety and hygiene, accreditation, and traceability—could be brought to bear, again, with a view to improving quality and reliability of product.

The anticipated outputs from a fund are compelling:

(i) A $20 million–$25 million investment fund,[33] managed by an independent team of investment professionals, deploying equity, quasi-equity, and debt in five to seven private companies in sectors related to herder/farmer livelihoods in Mongolia.
(ii) Targeted policy engagement and advocacy at the government level, and TA at the herder/farmer level focused on alleviating key bottlenecks impeding the development and vitality of value chains.

Rigorous monitoring, evaluation, and impact measurement framework assessing changes in beneficiary livelihoods, the effectiveness of TA and access-to-finance strategies where applicable, investee company maturation and supply chain development, and broader demonstration effects on the private sector and investment community in Mongolia as to the function and importance of equity. Beyond providing investors with the information required, the value of the framework will help investees further refine supplier engagement strategies.

Anticipated outcomes include:

(i) recalibration and optimization of value chains that depend on herders/farmers as suppliers;
(ii) recovery or preservation of pastureland in response to modification of herding practices driven by the commercial imperative of improving the quality and reliability of supply;
(iii) enhanced herder/farmer resilience to climate change, thereby safeguarding rural livelihoods;
(iv) strengthened medium-sized and larger enterprises in Mongolia—vital demand drivers within domestic value chains—reducing the need for costly imports of key goods, such as milk powder, and developing export markets for high-end Mongolian products; and
(v) demonstration of the viability of an integrated value chain impact facility in Mongolia by generating a positive net IRR to investors of 3%–5% per year in United States dollars.

This integrated value chain strategy will seek to harness the commercial imperatives of the private sector to help address three particular challenges at the herder/farmer, cooperative, and MSME levels. The sustainability of the strategy derived from aligning interests between investees and their suppliers to overcome the following challenges.

Herder/farmer, cooperative, and MSME productive capacity. The productive capacity of herders/farmers, cooperatives, and MSMEs in rural Mongolia suffers from rudimentary practices, poor quality control, lack of standardization and consistency, and limited financial literacy and business acumen. Forward planning, including cash management and fodder/feed stocking, is rare, resulting in persistent cash-flow crunches, especially as there are only two

[33] Positing an investment fund of this size may seem to contradict the arguments made regarding viable fund sizes in Section IV. It should be noted, however, that Mongolia is a unique market with its small population and large land area. Further, its socialist heritage (i.e., decades of military rule and a centrally planned economy) that only ended in the 1990s means that the private sector is still nascent. In the aggregate, this means that there simply would not be sufficient private companies to sustain a larger investment vehicle, unless it were to include vast investments in the extractive sector.

opportunities to generate cash per year. Herder-/farmer-led solutions have not materialized, due to lack of capacity and the expectation that the government is obliged to intervene at crisis points, such as during a *dzud* (especially harsh winters).

Despite privatization of livestock management 3 decades ago, herders are not taxed, do not make social security contributions, and receive tax-free pensions. Partly as a result of a subsidy mentality fostered by this dependence on the government, herders do not respond to demand in market-driven ways. Further, nomadic lifestyles, vast distances, and lack of capacity impede the effectiveness of cooperatives, let alone the formation of new ones. This results in foregone resource-pooling opportunities and economies of scale. In some sectors, such as cashmere, these problems are exacerbated by the presence of merchants from the Inner Mongolia Autonomous Region, whose inconsistent purchases at attractive prices encourage short-termism.

The integrated value chain response includes supporting facility portfolio companies in forming lasting relationships with suppliers (i.e., herders and fodder/feed farmers, cooperatives, and MSMEs), and building capacity and bringing TA and appropriate access to financing where needed. This aims to create a mindset shift based on long-term planning and increased product quality, incentivized by increased incomes and certainty.

Access to financing. The structure of the banking sector and dearth of financial products appropriate for herders/farmers contribute to the vicious circle of livestock mismanagement, overgrazing, and constrained herder/farmer cash flows. Mongolian banks generally avoid agricultural lending due to perceived risk and insufficient collateral. As they only accept animals as collateral from herders, all but 2 of 14 commercial banks focus on the construction sector and larger MSMEs based in the capital. On the limited occasions that herders can access financing from commercial banks, interest rates are punitive at 20%. Furthermore, as previously mentioned, herd-based collateral incentivizes quantity over animal quality, and with the national livestock headcount approaching an estimated 70 million animals or more by mid-2017, pastureland will come under further pressure.

The two commercial bank products currently available to herders/farmers illustrate the problem. Khan Bank makes loans available to herders/farmers, but uptake is extremely low due to collateral constraints. Immovable assets such as property are insufficient, and future harvests are not accepted. Moreover, animal value deteriorates over the course of the year, so even livestock has a sell-by date as collateral. Most herders are overindebted and registered as bad borrowers. Unsurprisingly, agricultural loans comprise less than 5% of Khan Bank's total portfolio. In addition, XacBank has provided MNT300 million ($125,000) in loans to small farmers since 2012 in support of the Organic Mongolia initiative covering Ulaanbaatar and environs. Uptake has been low, however, again reflecting poor borrower credit profiles. Crucially, it is a noninterest-bearing CSR initiative. This represents a market distortion, perpetuating poor borrower practices and a general mentality that the noble task of feeding the country justifies handouts.

Lack of enabling financial products. Banks have one-dimensional view of herders/farmers. By assessing them against traditional creditworthiness criteria, banks also forgo opportunities for new product development that would foster herder/farmer bankability. Such products include disaster insurance, crop insurance, microhealth insurance, warehouse and commodity-based financing, and factoring and reverse factoring. Banks miss opportunities

to gain exposure to herders/farmers by providing credit lines to companies that effectively advance key inputs and equipment on credit, deducting principal and interest thereafter from product purchases.

In addition to the above, there is almost no risk capital available in Mongolia for medium-sized enterprises.[34] Therefore, the only options for such firms to meet working capital and capital expenditure needs are self-financing or costly commercial bank debt. This squeezes companies' ability to develop the supply chain (for which, it should be noted, they are the only source of demand, because few Mongolian companies are integrated into international supply chains). For example, only the most cash flow-generative companies with strong balance sheets can provide cash advances or credit to suppliers to cover the cost of fulfilling orders. Another damaging impact is that such companies do not benefit from the partnership, knowledge transfer, and best practices that are infused when equity investment is done in a sound manner with interests aligned.

The integrated value chain response, however, makes risk capital available through the facility to companies that recognize the need to nurture and invest in the supply chain to develop value chains that drive company growth and therefore, necessarily, facilitate herder/farmer livelihood sustainability. Where possible, it also works with a financial institution to develop risk products to support herders/farmers, cooperatives, and MSMEs.

Lack of enabling infrastructure and sector-specific capacity. Using the term "infrastructure" to include physical as well as technical capacity to accelerate sector development, herders/farmers, cooperatives, and MSMEs lack a supportive operating environment. Environmental, social, and governance standards, phytosanitary standards, disease control, veterinary services, quality control, product standardization, storage, and warehousing facilities are all poor, limited, or nonexistent. Vast distances; rudimentary transport, distribution, and logistics; and severe weather 9 months of the year present significant challenges. This perpetuates value chain dislocation, because it undermines the viability of herder/farmer output; demand in the market for goods; and ability to store, organize, and transport them.

The integrated value chain response includes transport, logistics, distribution, warehousing, and storage as target sectors in the fund. When suppliers and purchasers have certainty that animals have adequate shelter, and that products can be stored, preserved, and then transported in an organized and reliable way, the certainty commands a market price. Thus, investments in such sectors can be very profitable while playing a key role in building healthy value chains.

Given the precariousness of herder/farmer livelihoods in Mongolia, an integrated value chain approach, underpinned by targeted policy engagement, is needed not only to safeguard the delicate ecosystem, but to realize the potential of the herding/farming economy in achieving economic, social, and environmental sustainability. Investment opportunities in the following six sectors can advance these objectives.

(i) **Meat processing.** Mongolians are avid meat eaters, and the pristine nature of most pastureland makes Mongolian beef especially flavorful. In addition to domestic demand for beef, pork, and goat meat, there are export opportunities for sausages,

[34] This is not the case for large companies in the extractive sector or large equipment providers.

cured meat, tinned meat, and other meat-derived products. There is even an imam in Mongolia qualified to bless animals for halal meat production for export to Xinjiang Uygur Autonomous Region in the PRC, Indonesia, Malaysia, and beyond. Some companies are also pursuing vertical integration strategies in pig farming, for example, to ensure a quality, disease-free supply of meat.

(ii) **Dairy.** Fresh milk production is challenging due to distances and lack of a cold chain. One solution is a hub-and-spoke system with local collection centers. Additionally, dairy products that travel well (i.e., withstand distances and extreme temperatures) have significant potential (e.g., ultra heat-treated [UHT] milk, milk powder, nutritional supplements, curd, cheese, and yogurt). The combination of local collection and production centers, around which herders/farmers can orbit nomadically, with targeted, more intensive cattle/goat rearing and farming in the greater Ulaanbaatar area, could boost production and demand enormously. With domestic dairy consumption rising by 15%–20% per year, and the high quality of Mongolian product over imports—milk powder is currently imported at high cost—the growth prospects for the dairy sector are compelling.

(iii) **Fodder and feed.** Underpinning almost every sector that the fund will target is the need vastly to increase the availability and affordability of fodder and animal feed. It also highlights the precarious linkages with most other rural activity in Mongolia. Hay preparation, silage, and storage are enormous challenges related to pastureland degradation and a burgeoning livestock count of 70 million or more. To the extent that government policy influences access to, and usage of, pastureland, it must underpin and reinforce an in approach predicated on livestock quality rather than quantity and, relatedly, pastureland viability and resilience. There are vast growth prospects in fodder and feed production combining improved inputs, technology, and know-how with investment in storage, distribution, modernization, and consolidation.

(iv) **Cashmere and wool.** Mongolia produces some of the world's highest quality cashmere in all four base colors are available (i.e., ivory, beige, light grey, and dark grey). Similarly, Mongolia has the world's largest yak herd, and yak down is gaining prominence as a fabric of cashmere-like quality. Camel hair and traditional wool are also produced in Mongolia. The fortunes of the cashmere and wool sector are entirely dependent on livestock supply and quality. There are opportunities for investment in cashmere and wool companies that, in addition to financing, need professionalization and export development, marketing, and branding expertise. Furthermore, supplier selection and engagement are vital because quality cannot be compromised, as the quality of Mongolian cashmere, wool and camel hair is already deteriorating due to overgrazing.

(v) **Leather, hides, and skins.** The potential of Mongolian leather, hides, and skins has yet to be exploited. The challenges are similar to those of the cashmere and wool sector, and grazing location is key, as tall, thorny grasses pierce hides and reduce quality.

(vi) **Storage, warehousing, and livestock shelter.** Like fodder and feed availability and access to financing, storage and warehousing of product and livestock shelter are critical to the rural economy. An effective integrated value chain approach requires both investment in these facilities and deep engagement with herders/farmers and cooperatives. Herders/farmers and cooperatives must learn to attach a market value and thus be willing to pay for fodder, feed, and storage because they safeguard livestock and product. Increasing their incomes as product quality rises will render such expenditures manageable.

This case study raises important questions on calibrating private equity funds with IB lending to address the missing middle more effectively. The missing middle does not exist in isolation; such entrepreneurs may struggle to access financing from formal sources, but they thrive throughout developing Asia in all of their informal, semiformal, and formal manifestations. The financing bottlenecks that they face must be alleviated, but the poor performance of many impact funds focused on small start-ups and early-stage businesses suggests that the fund tool, in its current form and on its own, is not working. Perhaps this is because impact investors have created a fanciful trifecta for themselves: there are myriad business models out there waiting to be scaled and replicated; access to finance will unlock this potential; and, creating an enabling ecosystem, whatever its exact meaning, will nurture businesses to growth and profitability.

Another way of looking at this is to ask if, in Silicon Valley—arguably the world's most conducive ecosystem flush with capital—many profitable business models that have achieved scale and been replicated can be named. Were they started with an angel investor or venture capital, and were they not loss-making for many years? Even today, aren't some not yet at break-even point and are not yet profitable?

VI

Conclusion

A. Realizing the Full Potential of Inclusive Business Financing

Building social capital. The focus on inequality has intensified in the 2010s. It is telling, for example, that inequality was the theme of the Annual Meetings in October 2017 of the World Bank Group and International Monetary Fund. Inequality is cited as a malignant source of social and political instability, often entrenched by economic structures that are maintained by and for a small but ever-wealthier elite. The environmental and social challenges posed by socioeconomic asymmetries and climate change do not, however, discriminate by wealth. Hence, even the world's most recalcitrant governments, wealth holders and business people are recognizing that sustainability is an imperative, not a choice. Whether out of self-interest or moral compunction, the billions of poor must be lifted out of poverty to achieve sustainable resource management, and the sustainable use of resources at the base of the pyramid must be matched by the same behavior at its apex.

The evidence from this report is that inclusive business (IB), as an investment, development, and economic growth strategy, can be a powerful contributor to the above objective. Recalling the World Bank's definition of social capital, "the institutions, relationships, attitudes and values that govern interactions among people and contribute to economic and social development," it can be seen how inequality and poverty erode such capital or prevent its agglomeration. IB, as an enabler of access and opportunity, is a potent antibody against this, as it builds social capital by enfranchising the excluded in enduring economic relationships. The shared goal, therefore, must be to accelerate the creation and expansion of sustainable IB. This requires financing, so optimizing deployment of IB financing to draw more resources into the approach is key.

Increasing the volume and value of inclusive business financing. Priorities include:

(i) **Designing appropriate products for a segmented opportunity set.** Products and hybrid investment instruments/structures must be designed that are segmented into a clear opportunity set that is straightforward for investors. The need for clarity is shown in the discussion on small funds and venture philanthropy (Section IV), not because innovation is unimportant, but because such strategies ignore the lessons of the past, and muddy the waters for investors unconvinced by impact–finance trade-offs. Just as Commonwealth Development Corporation (CDC) and investors in CDC funds recognized the experimental nature of its MSME offerings in the 1980s and 1990s, similarly, unproven strategies must carry a warning for investors to differentiate them from investor-ready products. Box 11 speaks to the significant advances that are being made in clearly labeled development finance products. It

remains to be seen whether the final products to emerge have an audience beyond the philanthropic, family office, and high net worth individual communities.

(ii) **Creating new fund structures and alternative modalities:** The risk-reward premium associated with MSME funds has improved little in 3 decades, other than for those targeting substantive expansion finance transactions (i.e., $2 million–$10 million). Perhaps the traditional fund model is not suited to the "S" of the MSME segment. Experimenting with the investment company model may be part of the answer if deploying equity, quasi-equity, and long-term debt in small businesses is to be made viable. However, hybrid fund structures are needed, along with new modalities yet to be designed. Fund economics are unforgiving, and small transactions are resource-intensive, so it may be better to act on the lesson than to repeat past errors, which curry no favor with mainstream investors.

(iii) **Ensuring local presence and capacity.** Many fund managers interviewed concurred that investors regularly cite weak deal flow when rejecting fund offerings. Yet deal flow is not the culprit; instead, the practitioner is. In other words, the problem is not that deal flow is weak, it is that not enough managers know how to generate it. As one former CDC investment executive reflects, "Good deals in the emerging markets are made, not found." Local presence, strong networks, and relationship building with prospective sponsors are key to developing and consummating deals. The dearth of such pipeline development skills may explain why countries with impact hubs (e.g., Bogotá, Colombia; Mumbai, India; and Nairobi, Kenya) are seeing unrealistic company valuations. Too many managers are chasing too few deals.

(iv) **Encouraging collaboration between financial institutions and funds.** As the case of Mongolia demonstrates, there is value in exploring how IB funds can work with financial institutions by calibrating top-down equity investment with bottom-up access to finance for suppliers. Each can take comfort from the presence and focus of the other; investees can rely on consistent supply, and suppliers can produce to consistent demand.

(v) **Promoting inclusive business IB funds of funds.** Because the supply of viable IB funds is limited, the fund-of-funds model can be useful for aggregating capital and creating portfolios of funds and exposure to deals diversified by size, theme, geography, and risk profile. More are needed. The reality is that few verticals other than agriculture, health care, and microfinance (already overcrowded) can sustain fund strategies in desired sectors. There are good reasons why sanitation or affordable housing funds are not found as stand-alone strategies, for example. The performance pressure on fund-of-funds managers is high, but diversification is their greatest ally. By taking a portfolio approach and blending funds with various risk profiles, if funds of funds can achieve mid-to-high, single-digit returns, then institutional capital, especially pension funds, will follow, nudged by pensioners and other stakeholders.

(vi) **Rethinking the role of development finance institutions.** CDC's foray into MSME funds from the late 1980s demonstrates DFIs' vital role in innovation. Leaving aside the anomaly that CDC was capital aggregator, manager and investor in its own funds, it developed MSME fund management expertise through trial and error. As shown in Box 11, there is a strong case for DFIs to help build the next generation of impact fund managers by seeding, mentoring, and even taking stakes in them until they become stable, independent investment houses. DFIs are the only entities with the mandate and patience to enable this fund manager journey. If they do not, the stock of viable IB fund managers will remain small.

Box 11: The SME Ventures Fund of the International Finance Corporation

The International Finance Corporation's (IFC) SME Ventures Fund provides risk capital and technical assistance to entrepreneurs and fund managers in frontier and fragile markets across the globe. IFC explains that

> "SMEs...have little access to the capital they need to thrive. They are typically too large to be served by microfinance institutions, yet too small and too recently established to be served by commercial banks. They also face other challenges, such as lack of management skills or industry knowledge."

Patient capital is required by SMEs, and if emerging fund managers who seek to provide such capital into the SME ventures window are segregated, they can be mentored and incubated. Implicitly, there is also an acknowledgement that while the need for such capital may be undeniable, funds seeking to deploy it must be ringfenced as works in progress because their viability remains questionable.

Source: International Finance Corporation. SME Ventures. https://www.ifc.org/wps/wcm/connect/Industry_EXT_Content/IFC_External_Corporate_Site/Funds/Priorities/SME+Ventures/

(vii) **Encouraging cooperation between financial institutions and medium-sized and large enterprises.** Medium-sized and large enterprises are key incumbents of supply chains and value chains. As such, they have a unique vantage point on the financing constraints experienced by producers, suppliers, and distributors. Some may develop supplier financing solutions by chance. Pragmatism may lead others to build warehouses for the goods that they need. From an IB perspective, a vast commercial opportunity lies in systematizing capital for these activities into financial products. Offtakers can break the collateral deadlock, which often dogs relationships between financial institutions and producers, suppliers, and distributors.

(viii) **Resolving the dilemma of the unheld hand.** Increasing IB lending exponentially is not enough; how to finance and deliver business development services to IBs alongside loans must be addressed. The smaller the IB, the more significant the need. Banks cannot afford this work and are not set up to tackle it. Moreover, many well-intentioned consultancies and NGOs also do not have the business-operating experience or financial skills to support IBs. Although there is no obvious solution, a starting point may be to pilot subsidized technical support teams within financial institutions, drawn from in-house staff and external sector experts with appropriate financial skills, to train their colleagues and to work on particular products or loan-size segments. If fragile junctures in IB growth, can be identified (i.e., when "finance-plus" engagement is most crucial), then limited resources can be targeted more effectively. For example, the moment when a small enterprise first hires one or two employees is especially precarious. Therefore, a 1-hour training session at a bank branch, or a two-page leaflet, could be enormously helpful to the business. Such interventions can be made in groups, allowing moderate scale.

(ix) **Increasing capacity in impact investing advocacy organizations.** Capacity needs to be built in impact investing consultancies, networks, and research organizations to ensure that their understanding of finance, investment, financial institutions, and fund management is proportional to the subject matter. To date, lack of capacity has

skewed disproportionate attention to social issues and measurement. One damaging consequence is that, having piqued the attention of mainstream investors with impact investing, such investors perceive products that are too heavy on the social, too light on the finance. At its core, the relationship between a fund manager and investors is fiduciary; banks are accountable to shareholders, and funds are accountable to investors. As such, they have a fiduciary duty to ensure that resources are deployed responsibly and in accordance with agreed criteria. A broadening of financial institutions' concept of fiduciary duty is overdue. It should take greater account of social and environmental responsibilities, opportunities, and even inclusion. However, it is unfair to expect banks to launch products or investment committees to approve funds that are suboptimal. Until the organizations advocating such products can better segment the experimental from the proven, the philanthropic from the commercial, impact and IB products will remain at the margins.

(x) **Creating clearer, more technical segmentation of fund offerings.** A cacophony of supplicants seeking investment exist who, in many cases, do not truly understand whether their offerings are venture capital, venture philanthropy, private equity, or something else. Impact investment and IB funds cannot expect to be taken seriously by mainstream investors unless the right (i.e., viable) offerings are reaching the right investors. This is not to say that investors should not venture beyond their comfort zones. They should. Why should a pension fund that has consistently invested in Asia and Africa not, perhaps, select a fund in another geography, or add health care to its agriculture and education portfolios? However, this is a different proposition to an inexperienced manager presenting a university endowment with a $30 million MSME fund, making average investments of $500,000 in early-stage health care companies in Indonesia, and expecting to be taken seriously.

(xi) **Engaging new asset owners.** There is a cultural dynamic in much of Asia that help explain the challenge of asset raising there. Anecdotally, most Asian wealth holders, especially of older generations, make a clear distinction between business and charity. There is an entrenched view that philanthropy and commercial endeavor should be segregated. Impact and IB offerings often elicit concerns about "making money off the poor" or "profiting from misery." Perceptions in Asia are evolving with generational change and wealth transfer, but slowly. One executive interviewed recounted a meeting with a multibillion-dollar foundation in Indonesia, during which the chief executive lamented, after 3 hours' discussion on a fund, "I would be delighted to invest, but my father and uncle simply will not understand or approve this. For them, there is work and there is charity. They just won't get it." Thus, approaches to asset owners must be context-specific. In Asia, the key task is to present IB as an adjacent, complementary strategy to philanthropy that enables sustainable solutions and re-deployment of returns.

In some developed markets, such as the United States, there is increasing focus on a mindset shift and regulatory changes required to attract asset managers and other institutional investors to impact and IB offerings. A balance must be struck between achieving credibility and consistency on the demand side of product (i.e., fund managers and financial institutions seeking allocations) and evolved thinking on the supply side.

Box 12: Voices of Practitioners: Innovations in Grant Structures for Inclusive Businesses

Elizabeth Boggs-Davidsen was formerly the chief of the Knowledge Economy Unit at the Multilateral Investment Fund of the Inter-American Development Bank.

For more than 20 years, the Multilateral Investment Fund (MIF), the innovation lab of the Inter-American Development Bank, has provided broad support to small and medium-sized enterprises (SMEs). In the past 2 years, the MIF has been experimenting with innovative ways to deploy and blend its toolkit of grants, equity, and debt to address meaningful barriers to financing that persist, including risk-averse local banks, misaligned investor expectations, high transaction costs, longer time horizons, limited assets, and small enterprise size. The problem for all SMEs and particularly for inclusive businesses (IBs) is finding the right type of financing that goes beyond traditional equity and debt and is better suited to the variety of models and markets in which IBs operate.

One funding solution is the MIF's new alternative grant instrument, recoverable grants, which differs from traditional grants in that it embeds the possibility of repayment. Recoverable grants are especially suited enterprises that are still in a proof-of-concept stage, where even risk capital is scarce, and when the potential social or environmental benefits may be so great that they merit high levels of subsidies before there is market traction. In such circumstances, a recoverable grant can be superior to debt or equity because of the lower cost of structuring, evaluating, and monitoring the investment. Recoverable grants are used, for example, to fund feasibility studies and to finance pre-investment costs before seeking other long-term funding sources. In some cases, IBs may access nonreimbursable grants based on the social or environmental benefits that they offer, but they may prefer a recoverable grant structure if they want to build a track record for attracting investment capital and want to signal to other investors that their models may become commercially viable.

The MIF has designed two new models of recoverable grants:

(i) **Early-stage innovation.** This provides an opportunity for the grant funder to participate in the profitability of an IB in the case of commercial success.
(ii) **Do not pay for success.** In this scenario, the grant funder is able to recoup the investment in the case of a failure on the part of the grant partner to meet predefined impact targets.

In the first model, the MIF has the intention to recover the capital or principal while also sharing the risk of failure. In the second model, the MIF is providing capital that is forgiven upon the achievement of impact targets.

In early-stage innovation models, the recoverable grant is structured as a convertible note that has no expiration and lacks liquidation payback rights. The investor is repaid when a predetermined milestone is achieved, such as reaching a certain level of revenue or closing a subsequent financing round. These grants target IBs that are beyond prototype and ready to launch a commercial pilot. As the grant maker, the MIF's primary goal is to help bring to market disruptive technologies addressing social issues. The recovery of the donated capital is contingent on the enterprise becoming commercially viable. The reimbursable grant removes the risk to the entrepreneur, as there are no financial costs or interest rate obligations unless the enterprise succeeds.

In structuring the grant, there is a predefined level of minimum commercial viability (MCV), typically in terms of cumulative revenues. Once this level is reached, the enterprise is required to

continued on next page

Box 12 *continued*

repay the funding. If the company does not reach the MCV, there is no obligation to repay. The MIF bears the risk of MCV not being reached. Once the MCV is reached, however, repayments are based on a percentage of revenue and are scheduled with fixed semiannual amounts with a grace period. Repayment obligations increase gradually with subsequent revenue milestones until 100% of the disbursed grant is recovered. The financing has no interest rate. As such, there is potential upside for the MIF with a liquidity event: a negotiated equity conversion right is triggered if the company is sold to a strategic buyer. The MIF also has the right to participate in future financing rounds. As a risk mitigation strategy, the MIF requires the IB to secure counterpart funding (i.e., the risk-sharing concept), and to seek investors who can finance and provide value-added advice during the ramp-up phase.

In the do-not-pay-for-success models, the recoverable grant has a call option-like feature that places the obligation to repay on the grant partner until a certain milestone is reached. The reimbursable grants are originally treated more like a liability, with a preset expectation that the grant will be reimbursed. Once the grant partner reaches the threshold targets that are agreed at the outset of the project, it can request the MIF to eliminate the obligation to pay.

This model is used to finance an intermediary organization (i.e., grantor) providing business acceleration support to early-stage and growth IBs. The grant is linked to predefined targets for the intermediary organization and the underlying enterprises it is supporting. If the targets are met, the grant partner is not required to reimburse the grant, thereby aligning incentives of the grantor and grantee.

The MIF and grant partner arrive at predetermined IB acceleration targets. The MIF provides a grant to cover much of the cost of the IB acceleration activities for up to 3 years. The successful achievement of the agreed targets by the grant partner triggers discounts that could reduce the repayment of the reimbursable grant to zero. Accordingly, this model proposes a grace period of 3 years (to execute the project and achieve results) and a subsequent repayment period of 3 years. During the repayment period, an independent consultant/auditor issues annual reports on the status of the agreed targets and determines whether the grant partner is eligible for a discount. The discount is triggered if the grant partner achieves 80%–100% of the agreed targets and does not increase if the grant partner achieves more than 100% of the targets. The maximum amount of the discount equals the full amount of the reimbursable grant. Accordingly, if the grant partner delivers on all the targets agreed, the repayment is equal to zero. The total discount is evenly distributed during the repayment period (years 4, 5, and 6), and the achievement of each target is tied to a fixed discount amount.

The MIF's experimentation with reimbursable grants is part of a growing interest in developing alternative financing instruments to meet the needs early-stage IBs. Many development finance institutions and other impact investors are now innovating to develop and implement new solutions that go beyond traditional equity and debt, and that are better suited to the variety of business models and markets in which IBs operate. This emerging marketplace of new financing models is the subject of a report recently launched by the MIF, *Innovations in Financing Structures for Impact Enterprises: A Spotlight on Latin America*. The report provides a rich overview of many alternative financing structures, including the reimbursable grants, to support early and growth-stage IBs.

Source: A. Armeni and M. Ferreyra de Bone. 2017. *Innovations in Financing Structures for Impact Enterprises: A Spotlight on Latin America.* Washington, DC: Inter-American Development Bank.

Box 13: Voices of Practitioners: Impact Investing—Shaping the Markets of the Future

Fran Seegull is the executive director of the U.S. Impact Investing Alliance, incubated by the Ford Foundation. The alliance works to build the field of impact investing in the United States, fostering deployment of impact capital and building a conducive ecosystem.

In a changing, increasingly volatile world, investors are reassessing how they evaluate financial choices. Alongside risk and reward, new measures of social and environmental impact are increasingly important. In part, there is a realization that the costs of social and environmental externalities will eventually appear on the bottom line. There is also rising impatience with the response to global challenges like poverty, income inequality, and climate change. Couched between those two motivations is the reality that businesses built for a world gone by must adapt or perish, while businesses built to address systemic threats and opportunities are destined to flourish.

The U.S. Impact Investing Alliance's vision is to see measurable social and environmental impact placed alongside risk and return in every investment decision made. It works with asset owners to help them understand the opportunity set and, more broadly, to build an impact investing ecosystem that empowers them to deploy capital for impact across asset classes.

To be clear, the alliance views this work as an imperative. Global population growth is straining natural and human-made systems alike. Pressure to steward dwindling natural resources will grow, while a changing climate threatens lives and businesses. All the while, consumer demand shows little to no sign of abating, presenting a financial opportunity for firms able to navigate the cross-currents.

To understand what this dynamic looks like in practice, one parable from the global financial crisis can be illustrated. As the fragility of interconnectedness was laid bare for all to see, some investments were spared the worst. As collateralized debt obligations and synthetic derivatives melted down, the community development finance institution (CDFI) industry continued to produce modest returns while serving a market overlooked by traditional investors.

CDFI investors do expect a return, and so demand strong balance sheets, good governance, and sustainable business practices. A CDFI investor is also looking to provide affordable capital to communities in need, avoiding predatory rates and seeking reasonable creditworthiness. CDFIs and their investors are also often intensely focused on the places that they serve, engendering an understanding of and respect for community needs. To the traditional investor, the notes issued by CDFIs may have seemed concessionary before the crisis, and yet in its wake, they looked like shrewd business. In the presence of systemic risks, investors who seek out good governance, sustainable practices, and aligned impact benefit are often rewarded by the fact that, in essence, they are creating value.

The alliance believes that environmental, social, and governance criteria have a material impact on financial performance. What the postcrisis experience with CDFIs shows is that the same can often be said for impact metrics. Companies that go beyond simple harm reduction and actually seek to address complex and long-standing challenges are at the forefront of defining new markets and creating new investible opportunities.

Take food systems, for instance. For decades, agricultural and food processors have been driven by profit motives to drive down costs, resulting in highly processed and unhealthy offerings,

continued on next page

Box 13 *continued*

especially in poor communities. Despite the toll that this model has taken on individuals, communities, and the environment, this is the outcome that traditional investors were demanding. Today, however, change is coming. Firms like Revolution Foods in the United States have forged new business models from the creation of healthy alternatives to low-cost school meals. The goal of investors in Revolution Foods is to target the root causes of diabetes and obesity, especially in public schools. But they also recognize that these are complex and long-standing problems demanding sustainable solutions. That is why it is so encouraging to see that consumers—both institutions and individuals—are responding to and embracing their mission.

Many of these early proof points in impact investing are funded by smaller, nimbler pots of capital, such as family offices, and philanthropically motivated investors willing to place bets on early concepts. The impact of moving these dollars is significant, but far more important is how such investors are influencing broader markets. Ultimately, addressing global challenges will demand a recalibration of the capital markets, both public and private.

Some of the largest institutional investors are beginning to move. However, the movement is usually initiated by an external mandate from a government, pensioner class, or another stakeholder group. For example, a state pension fund in the United States looks to invest in development and entrepreneurs in their own communities, a nurses' pension in Denmark makes the decision to invest in companies that improve maternal health outcomes; and a corporation finds that sustainable retirement plan options improve recruitment and retention.

At a policy level, governments have begun to redefine fiduciary duty. In the United States, the departments of Labor and Treasury have issued various pieces of guidance, interpretations, and regulations to demonstrate how a responsible investor can evaluate impact factors. These changes do not compel any institution to modify its investment policies, but they open the door while encouraging investment committees and boards of directors to ask what to do differently and about the opportunities for doing so.

Governments can also provide critical incentives to help align the needs of communities with the investment objectives of capital markets. In the United States, the New Markets Tax Credit, Low-Income Housing Tax Credit, wind and solar tax credits, and the Community Reinvestment Act have each played instrumental roles in helping emergent impact investment themes form and grow. When structured well, these policies can leverage many times the value of taxpayer investments in the form of private investment.

It is also possible for philanthropically motivated investors to play the role of providing limited subsidies to prove concepts, de-risk early stage investments, and place an imperative on impact objectives. The classic example is of microfinance where, after more than 20 years and $20 billion in subsidies, what started as an unproven development tool is now treated as an institutional-quality investment option.

The opportunity for impact investors is to leverage early successes to draw institutional adopters further along. Investments in promising solutions have the potential to be catalytic when taken to scale. Through these early days, impact investors are building the market structures—products, intermediaries, and professional services—that will ultimately be able to serve the much larger demands of institutional investors. By exploring new opportunities to prove both the impact and business cases, impact investors are working today to shape the markets of tomorrow.

B. Final Thoughts

The twin scourges of poverty and inequality demand urgent responses. As resource constraints intensify, so do the malignant effects of poverty and inequality in the social, environmental, economic, and political spheres. Climate change will only exacerbate the challenges and accelerate the need for solutions. Recalling C.K. Prahalad's central argument, that inclusion is *the* commercial opportunity by volume and value, efforts must be redoubled to optimize the modalities providing capital to IB.

This report has explored some of the prominent challenges in mainstreaming IB financing. Three priorities are highlighted for immediate attention:

(i) Well-managed, investor-ready products must be brought to the attention of many more investors, who need to be educated that inclusion can drive financial returns and vice versa.
(ii) Opportunities to support IB entrepreneur/SME onboarding, then progression, and to achieve impact at scale through lower-middle market expansion finance must be publicized more broadly, while DFI and concessional capital is used to achieve proof of concepts in areas of the impact tent under construction.
(iii) Key stakeholders—governments, regulators, and legislators—must be alerted to the versatility of IB as a policy tool.

At a time of polarization and populism, inclusion speaks both to conservatives seeking reductions in public spending in favor of private sector-led investment, and to their opposites who decry the inadequacy of resources directed to redressing socioeconomic imbalances and environmental ills. It is the hope of the author that this volume sheds light on how the full potential of IB financing can be harnessed as an intersecting commercial and developmental strategy.

Inclusive Business Financing

Where Commercial Opportunity and Sustainability Converge

Reducing poverty and inequality requires innovative modes of financing. By enabling the poor to engage more fully in economic activity and participate in supply chains and value chains, inclusive businesses help them to increase earnings and accumulate wealth. This is why inclusive businesses are gaining prominence as an effective response to socio-economic and environmental challenges. Understanding how best to finance them will accelerate inclusion and poverty reduction. Written as a resource for finance practitioners, financial institutions, fund managers, and development finance institutions, this report builds on the notion that engaging marginalized and commercially-excluded people is vital—and that it can be done profitably. Drawing on case studies from across Asia, it examines the two main conduits for financing inclusive businesses: bank debt and private equity.

About the Asian Development Bank

ADB's vision is an Asia and Pacific region free of poverty. Its mission is to help its developing member countries reduce poverty and improve the quality of life of their people. Despite the region's many successes, it remains home to a large share of the world's poor. ADB is committed to reducing poverty through inclusive economic growth, environmentally sustainable growth, and regional integration.

Based in Manila, ADB is owned by 67 members, including 48 from the region. Its main instruments for helping its developing member countries are policy dialogue, loans, equity investments, guarantees, grants, and technical assistance.

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