

# Priming the Pump:

The Case for a Sector Based Approach  
to Impact Investing

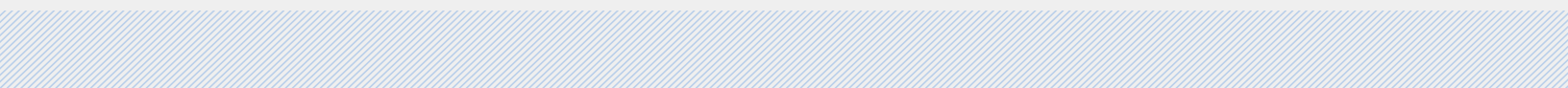
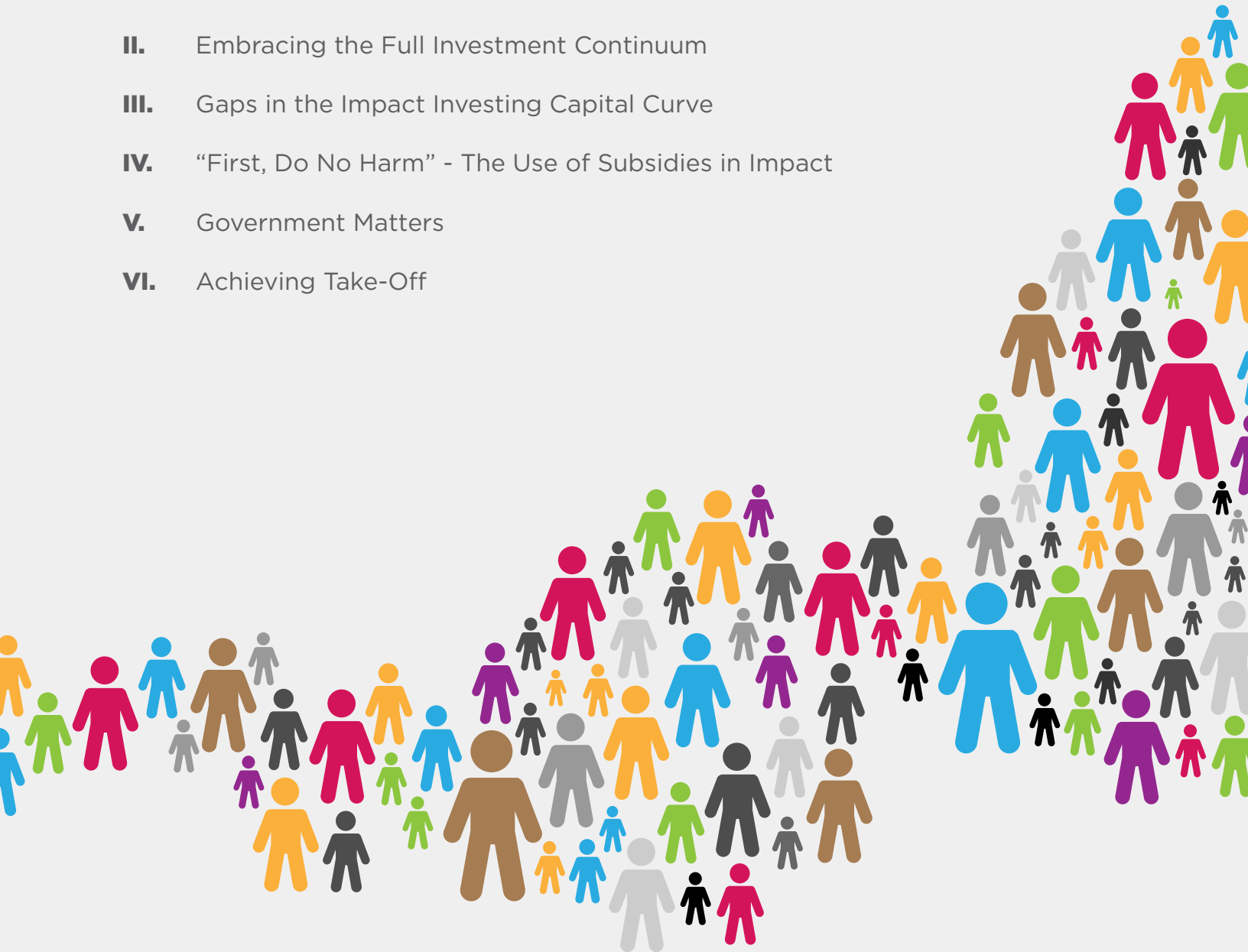
By Matt Bannick & Paula Goldman



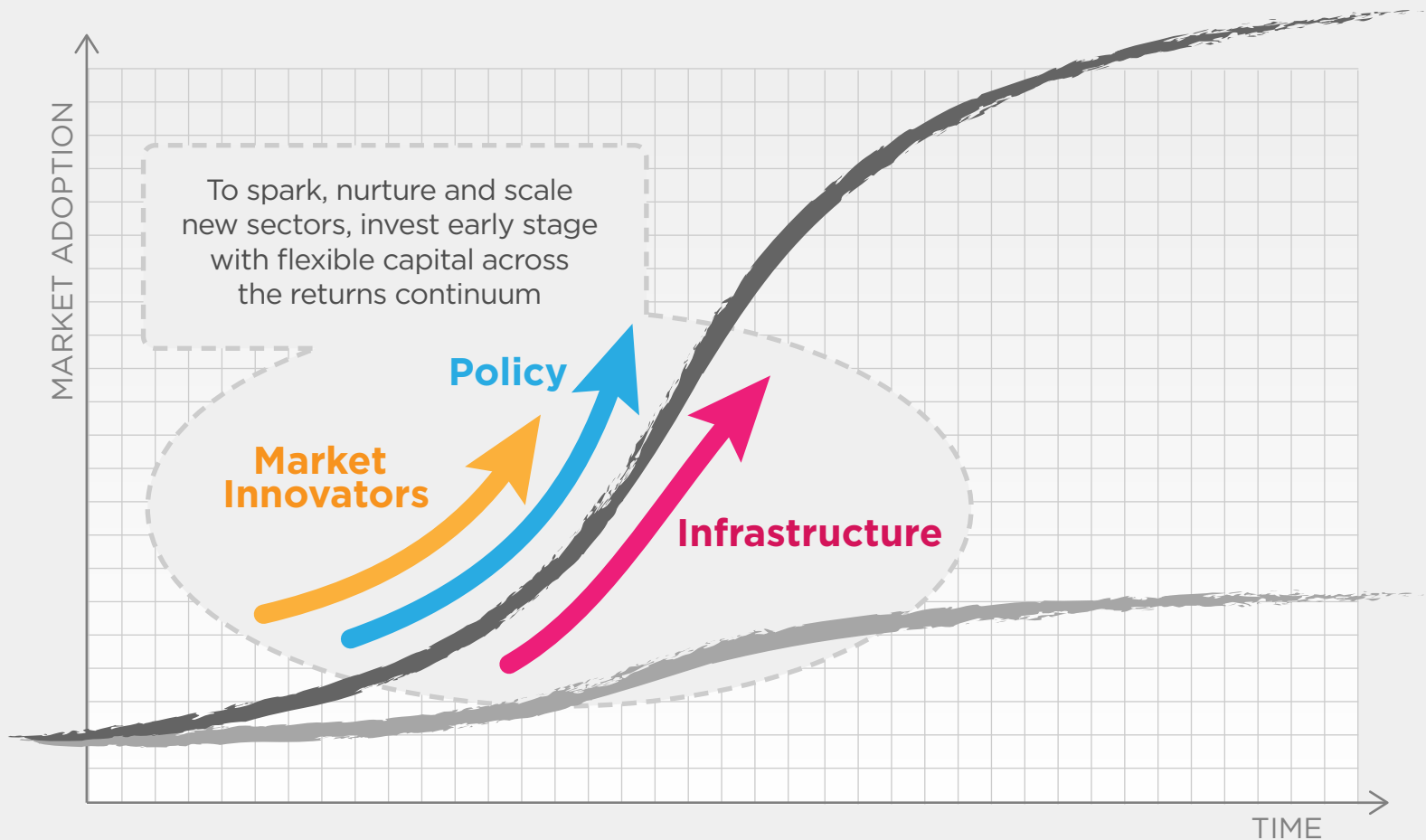
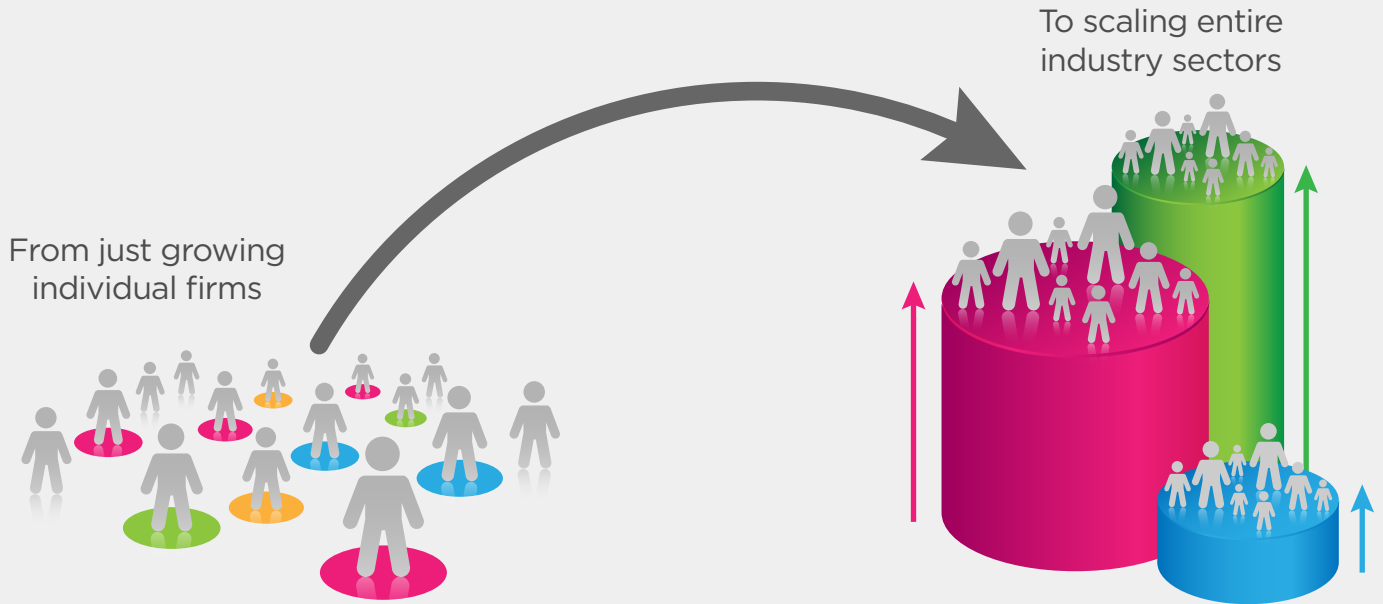
OMIDYAR NETWORK™

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# Impact investing needs a shift in focus.



I.

## Sectors, Not Just Firms



It was roughly five years ago, in a late summer gathering of investors and thought leaders, that the term “impact investing” was coined. The practice, of course, is more than five years old. Omidyar Network, for example, had been investing for both social and financial returns since 2004.

In the past five years we’ve seen an exponential growth of interest in our industry, much of it focused on individual firms. Most impact investors see their primary goal as finding and investing in enterprises that yield strong financial and social returns—a goal we share and support. But we worry this singular focus may miss the forest for the trees.

In this discussion paper, we argue for a shift in focus—toward the goal of scaling entire industry sectors, in addition to individual firms. Our experience from the past eight years is that impact investors can massively increase the number of lives they touch by concentrating investments in specific industry sectors in specific geographies, and by investing in a range of organizations to accelerate the development of these industry segments. The need for investment is particularly acute at the earliest stages of innovation, which provide the foundation in which entire new sectors can emerge and scale rapidly by tapping commercial capital markets.

Creating and scaling entire sectors can make the difference, for example, between support-

ing one solar lantern company that can provide safe lights to thousands of children who otherwise can’t study for school at night—and accelerating an *entire solar lantern industry* that could provide these lanterns to millions, if not hundreds of millions of students.

### Tools for the Journey

Easier said than done, you may rightly be thinking. After all, many industry sectors, especially those serving disadvantaged populations and with weak infrastructures, can take decades to develop. Microfinance, one of the most heralded innovations for the poor, first emerged in the 1970s and, despite strong growth, is still available to only a minority of the world’s poor.

But consider this. Accelerating the development of the microfinance sector by just three or four years means extending critical financial services to tens of millions of people—well above the scale than any single firm can reach.

The nascent medical technology sector serving the base of the pyramid in India offers another example of the potential of market acceleration. According to a 2011 study by McKinsey & Company, accelerating the growth trajectory of the affordable medical technology sector in India by just three to four years could mean that poorer consumers

have access to an additional two billion medical treatments per year by 2015. For some of those customers, having access to such treatments could mean the difference between life and death.

In this paper we offer several ideas on how to spark, nurture, and scale new sectors for social change. In Section II, for example, we lay out three specific types of organizations that together help build an industry sector—innovators, scalers, and infrastructure players. Each of these organizational types has very different risk and return profiles, but they all need to be adequately capitalized in order to speed up the development of any given sector.

The paucity of financial and human capital available for high-risk, early-stage ventures (what we call “innovators”) and for sector-specific industry infrastructure poses a massive impediment to the healthy growth of the impact investing sector. Everyone loves to invest in the occasional impact investing “homerun” that promises strong financial and social returns—and these homeruns have an important demonstration effect for the viability of the industry as a whole. Unfortunately, relatively few appear willing to step up to the hard and uncertain work of sparking and nurturing the innovations that ultimately generate a robust flow of investable, high-return impact investments. It is as if impact investors are lined up around the proverbial water pump waiting for the flood of deals, while no one is actually priming the pump!

An excessive focus on the individual firm, we believe, also has caused many impact investors to underestimate the importance of policy and political sensitivity, particularly when serving the disadvantaged. In Section IV, we detail how three policy levers—promoting competition, ensuring consumer protection, and promoting entrepreneurship—can speed up or delay the development of industry sectors, often by decades. We also note how a lack of appreciation of political dynamics can cause firms, and entire sectors, to suffer serious setbacks. Oddly, despite the dramatic fallout of microfinance in the Indian state of Andhra Pradesh, there seems to be relatively little discussion of the extent to which profit-making firms serving the disadvantaged are particularly vulnerable to backlash from a

We realized that if we truly cared most about sector creation, then we needed to develop a way to account for the total value creation of the firm, including sector value creation as well as the firm’s social impact and financial returns.



wide array of players, including concerned politicians, a skeptical press and citizenry and entrenched economic interests.

## Our Own Evolution

Pierre and Pam Omidyar established Omidyar Network with a uniquely flexible structure—enabling us to deploy whatever type of capital, whether grants or for-profit investments, we thought could best help solve a problem. Pierre believes that for-profit firms might have advantages in achieving rapid scale that are unavailable to many non-profits—such as access to commercial financing and the ability to reinvest profit to sustain growth. To date, Omidyar Network has invested more than a half a billion dollars in typically early-stage social impact organizations, almost equally split between for profit and not-for-profit investments. Many of the observations and insights in this series come from our own explorations about how best to take advantage of [our flexible structure](#).

As we were refining our approach to driving sector-level change, we noticed lots of new investors piling into the impact investing arena, many with the expectation of finding a steady stream of relatively mature businesses offering both social impact and risk-adjusted returns. We have found a real shortage of such deals.

Concern over inadequate deal flow was one of several factors that led us to reevaluate our

own approach to what we referred to as the “gray space” between grants and risk-adjusted return investment. Historically, we were always comfortable with traditional grant making, where we expected one hundred percent loss of principal. But when we did for-profit investments, we insisted on deals that would yield risk-adjusted commercial rates of return. This was driven by concerns about distorting markets and the desire to be as rigorous as possible in our investments. With time, we realized that this insistence on risk-adjusted returns would cause us—and the impact investing industry as a whole—to systematically under-invest in creating the conditions under which innovations—and entire new sectors—could be sparked and scaled.

Since 2007, we have invested in businesses that we did not expect to earn risk adjusted returns, but which we DID expect would help advance entire sectors. For example, in 2008, we invested in [MFX](#), a company that helps microfinance institutions decrease the foreign exchange risks of borrowing money in western currencies and lending out in local currencies. MFX is a for-profit company, but we knew we might not achieve risk-adjusted returns on our investment, and discussed this question in great detail. We decided to move forward, because we were clear that MFX would make a large contribution to accelerating the microfinance sector as a whole.

We realized that if we truly cared most about sector creation, then we needed to develop a way to account for the total value creation of the firm, including sector value creation as well as the firm’s direct social impact and financial returns. This led us to refine the process by which we consider investments across the entire returns continuum, from grants to risk-adjusted returns—and particularly those that fall in the middle of the spectrum. While this has required much greater discipline around identifying sector-level value creation, we also think it has given us new tools for priming the pump for sector-level change.

The observations, insights, and changes that we will highlight in this paper were, for us, neither immediately obvious nor easy to adapt. The appropriate role of below market returns, for example, continues to be the source of considerable debate within ON and across the sector. More broadly, the impact investing sector remains in its infancy and we are just beginning to examine critical questions, such as how to create entire new markets for social change. Our insights will grow and deepen in the years to come.

Though we are eight years into our journey, we are still on a steep learning curve. Our intent with this series is NOT to try to present the definitive blueprint on how to spark, nurture, and scale entire new sectors for social change. We are committed, rather, to contributing our experiences and thoughts to the ongoing dialogue that is shaping the incredibly promising impact investing sector. We invite you to participate in this dialogue with us, to push back, to help us refine our own thinking. Even more importantly, we invite you to collaborate with us on this challenging but critically and inspiring journey. To truly scale sectors in impact investing, we will need all hands on deck.



II.

## Embracing the Full Investment Continuum



In the previous section, we argued that the impact investing sector should focus more on what is required to spark, nurture, and scale entire sectors for social change. Though investing in firms is an essential component to driving sector-level change, it is ultimately sector development that matters the most. As Alvaro Rodriguez of the impact investing fund Ignia has written, “Single firms are born, they mature, they get lazy and they die. But industries prosper over time and reach scale as competition fosters the delivery of better products at lower cost.”

We also described Omidyar Network’s evolution toward greater willingness to experiment with all the tools necessary to drive sector-level change. One of the things that ON has realized is that we invest differently when we consider a firm’s sector impact. If we do NOT consider sector-level impact, we are likely to under-invest in organizations—particularly early-stage, high-risk innovative firms—that have the potential to create a new industry sector or fundamentally transform industry sector dynamics.

Three key insights emerged from our exploration of this topic:

### 1. Social impact needs to be measured at the SECTOR as well as the firm level

The impacting investing community has made significant strides at developing tools for assessing the social impact of individual firms. Efforts such as [GIIRS](#) and [IRIS](#) give impact investors a taxonomy to benchmark how firm-level outputs contribute to social change. For example, if you’re a health care provider, we could record the number of patients treated and what the outcomes were and then compare those results to others in the field.

Absent from these measurements, however, are the positive externalities your firm may create for the sector as a whole. For example, your company may be the first entrant in a market where regulatory structures are weak, management talent scarce, and customers are highly suspicious of the efficacy and safety of your offering. While you may not be able to reach of millions of people on your own, your own trial-and-error efforts may develop a new model that lowers the risk and makes possible the entry of later health care providers that in turn can touch tens of millions of lives.

In essence, we are arguing that:

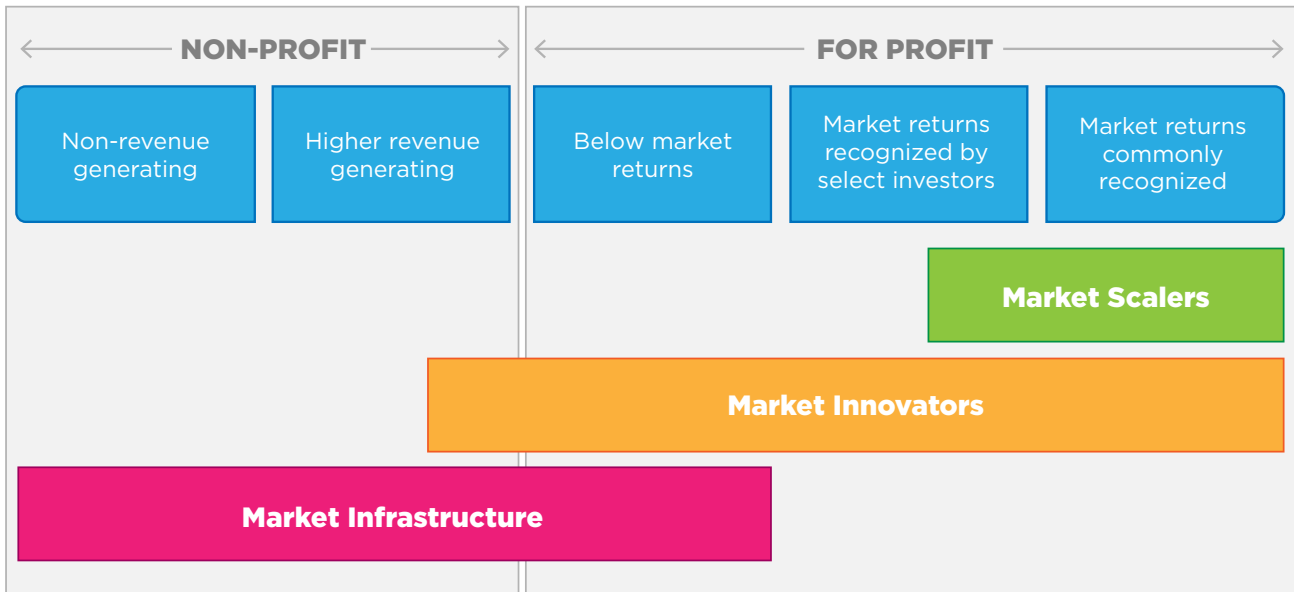


This insight stems from the work of pioneering impact investors, such as the [Ignia](#) fund, which has recognized that some firms in its portfolio are facing both sector and business risk and that each type of risk creates different challenges and necessitates a different investment approach and set of expectations.

## 2. Three Categories of Actors

Our analysis suggests that firms/organizations can be broken into at least three distinct categories according to their impact in growing an industry sector. It's important to note that the generalizations below are derived from our experiences serving markets with disadvantaged or poorer customers; they do not always apply to higher income market segments. We would also emphasize that this typology is meant to apply to the development of for-profit markets for social impact, not necessarily for social impact sectors that are covered primarily through grant-making.

### Investment Continuum: Expected Returns





## Market Innovators

These are the trailblazing entrepreneurs and teams that believe in a product or service well before its profit potential is obvious to most established investors. They contribute meaningfully to advancing a sector by de-risking the generic model of an innovation or product. Some sector innovators, though not all, will also be able to scale up on their own as individual firms.

### *Example:*

Bridge International Academies is pioneering low-cost, high quality education for poor schoolchildren in Kenya, using a “school in a box” model that standardizes innovations in service delivery for easy replication. Because this was the first of its kind, and sector risk was high, many of Bridge’s early investors were motivated more by philanthropic intent and did not expect market rates of return. After several years, Bridge has managed to de-risk the model considerably, scaling to 82 schools—significantly increasing its own valuation and attracting more mainstream investors. More importantly, Bridge has now defined a model that can be replicated by others. Indeed, this may be Bridge’s biggest contribution, just as Grameen and BRAC’s biggest contribution to microfinance was the model itself.

### *Returns expectations:*

Market innovators exist across the returns continuum—from revenue-generating non-profits, such as microfinance pioneers in the

1970s, to firms such as Bridge Academies International, which has the chance to generate market rates of returns. In general, however, market innovators are the “high beta” investments of the impact investing world; returns are highly uncertain. In our view, this is where there is the biggest need for socially motivated impact investors to take appropriate risks and to invest in the human as well as financial capital required to help ambitious entrepreneurs refine and scale up their world-changing ideas. A long-term view is also essential, as innovators can take many years to become commercially viable. Monitor research, for example, suggests that most businesses serving millions of poor customers in India took at least 15 years to reach scale.

### *Open issues:*

We need better ways to measure and predict meaningful contributions to de-risking a sector, so as to ensure disciplined investing. Extreme caution is also necessary to minimize the likelihood that a subsidy might inadvertently distort and slow market development. Finally, we would note that there is a shortage of impact investors who are willing to dedicate the considerable time, energy, and cost required to nurture early-stage, high-risk market innovators. More on all these issues later in the series.

## Market Scalers

Market scalers enter a sector after a generic model has been de-risked. They accelerate the growth of a sector by scaling as individual firms. They may also tend to refine and enhance the generic model.

### *Example:*

Grameen Bank took 15 years to reach its first million customers with its pioneering model of microfinance, while Indian microfinance firm Equitas (which entered the market in 2007, nearly 30 years after Grameen) scaled from zero to one million plus customers (and from one to 40 million dollars in revenue), in less than five years. The most successful market scalers are able to expand rapidly by tapping commercial capital markets; in the process, they are able to extend access to needed goods and services to millions in need.



“Single firms are born, they mature, they get lazy and they die. But industries prosper over time and reach scale as competition fosters the delivery of better products at lower cost.”

*Returns expectations:*

Market scalers are more likely than market innovators to achieve risk-adjusted market rates of return. Indeed, it is critical that many market scalers DO earn risk-adjusted returns, as this is the most viable means of raising enough capital to scale up to serve millions. It is important to note that given the high-risk environment in which many market scalers operate, they may sometimes still be perceived by mainstream investors as too risky. Impact investors with local and/or deep sector knowledge are more likely to understand the returns potential.

*Open issues:*

If financially successful, market scalers (and indeed highly profitable market innovators as well) are likely to raise concerns about mission drift and “appropriate” levels of profitability—as evident in the intense debate on the role of commercial microfinance. Successful enterprises serving disadvantaged populations also face tricky political issues, as their very success may threaten entrenched economic interests or raise concerns among politicians who view themselves as advocates for the poor and may be uncomfortable with private sector approaches to social problems. More on this, too, in a later section.

## **Market Infrastructure**

Industry players often have common needs that are most economically served in collective form. Infrastructure players advance a sector by addressing these collective needs, thus helping to build a supportive ecosystem for entrepreneurial innovation.

*Example:*

Many different categories of infrastructure exist, from industry associations (e.g., GSMA’s Development Fund, which works to increase access to mobile financial services to the poor, among other goals) to information exchanges (e.g., the MIX, which provides financial data and social performance metrics for microfinance).

A sector-level view is relevant far beyond microfinance. We see strong potential for other sectors to accelerate as well—from low-cost education for the poor in emerging economies (being pioneered by Bridge Academies, among others), to mobile payments platforms (such as those enabled by M-PESA).



*Financial returns expectations:*

Often, though not always, market infrastructure organizations can find ways to derive revenue from the services they provide, and sometimes even can cross the threshold toward profitability; however, they are rarely hugely profitable.

*Open issues:*

Market infrastructure organizations should strike the right balance in pursuing revenue streams for sustainability and growth. While charging for services allows organizations to test their value proposition, not all forms of industry leadership can be easily monetized, especially in the earliest stages of a sector. If they are to be sustained, therefore, these infrastructure organizations need to be able to demonstrate their value—either to paying members or grant-making organizations. We would also note that LACK of infrastructure can disrupt an otherwise burgeoning sector, and that many times the infrastructure needs to be developed at a national level. The lack of a credit bureau serving Indian microfinance institutions (MFIs), for example, contributed to the over-indebtedness problem that was a significant contributor to the microfinance crisis in the state of Andhra Pradesh.

### 3. Investments in all of these different vehicles and returns profiles are necessary to move a sector

It's commonly known, for example, that most early MFIs started out as grant-funded NGOs. After early-stage innovators demonstrated the generic model to be commercially viable in the late 1990s, sector growth was driven largely by scalars, many of whom were able to tap commercial capital markets. These for-profit firms (many of which converted from not-for-profits), brought financial services to additional tens of millions of previously excluded people. All along the way, infrastructure organizations such as the Consultative Group to Assist the Poor (CGAP) and the MIX played a key role in enabling this scale.

Omidyar Network contributed to the growth of microfinance by investing more than \$100 million across 28 organizations, 15 not-for-profits, and 13 for-profits. Roughly two thirds of our funding went to organizations helping to provide financial services for the unbanked; the other third went to infrastructure groups, such as MFX (a currency hedging facility for MFIs) and the IFC's global credit bureau program.

A sector-level view is relevant far beyond microfinance. We see strong potential for other sectors to accelerate as well—from low-cost education for the poor in emerging economies (being pioneered by Bridge Academies, among others), to mobile payments platforms (such as those enabled by M-PESA). We believe that to scale up, such sectors need to ultimately produce the “win-win” (high social return, high financial return) investments that will enable them to tap the commercial capital markets.

But before we can tap capital markets to enable sector lift off, it will take high-risk tolerance, hard work, and persistence to identify, fund, and support the best market innovators and infrastructure organizations required to kick-start the process of sector development. More on this in the next section .



### III.

## Gaps in the Impact Investing Capital Curve



In Section II, we described three distinct types of organizations—innovators, scalers, and infrastructure players—which together can spark, nurture, and scale entire sectors for social change.

But capital is not evenly available for all these types of organizations. Not surprisingly, most impact investing capital appears to be available primarily to scalers—firms operating in sectors that have already been substantially de-risked and which offer the prospect of strong financial and social returns. By contrast, innovators and industry-specific infrastructure firms often struggle to raise necessary funds and to get the human capital support often so critical to success. Indeed, capital appears to be thinnest precisely where it is needed the most: to prime the pump of innovation and deal flow.

### The Innovator's Deficit

The biggest funding gap, by a wide margin we believe, is for early-stage innovators. There are very few impact-oriented investors willing to assume the high risks and uncertain and/or low returns associated with investing behind socially impactful early-stage businesses, particularly in geographies and industries where sector risk is perceived to be high.

This deficit was described extensively and compellingly in the Monitor Group's recent report, "[From Blueprint to Scale: The Case for Philanthropy in Impact Investing.](#)"

In 2010, JP Morgan and the Global Impact Investing Network estimated that the impact investments in the developing world would grow to between \$400 billion to \$1 trillion dollars worth of capital deployed within the decade. Although good data is hard to come by, it appears that the percentage of this capital flowing to early-stage investments in companies serving disadvantaged populations is quite modest—probably ranging in the low hundreds of millions of dollars globally per year. These estimates are based on activity levels of a handful of leading players doing early stage impact deals in the developing world.

For example, Acumen Fund, one of the pioneering investors in impact investing for the base of pyramid has committed roughly \$73 million in investments over 10 years. Gray Ghost, another early-stage industry pioneer investing in low income communities, has committed a similar amount of capital—\$100 million since 2003. Other leading BOP investors boast similar ballpark figures, for example Elevar (\$94 million since 2006), Ignia

(\$48 million since 2007), and Aavishkar (\$53 million since 2007). Of the \$550 million of capital that Omidyar Network has deployed since 2004, more than \$250 million has gone to early stage BOP investing, about a third of which went to grants.

Early stage investing requires not only a keen understanding of the market and excellent business judgment; it also requires a commitment to identifying top entrepreneurs and helping them scale up their capabilities and their team. It is quite common for the costs of these human capital efforts to exceed the size of the financial commitments, particularly given the small dollar amounts invested in early stage innovators.

Omidyar Network's average deal size for early stage deals in the developing world is about one to two million dollars. This is a modest size for a developed world venture capital investment, but a large amount of capital for an early stage firm in places such as India. Indeed, recent research by the World Bank, for example, suggests the gap in early stage funding for the BOP in countries like India is not just at the typical venture capital range, but at the angel and seed stage (tens to hundreds of thousands of dollars per deal instead of a million dollars or more). Of course, even decent financial returns on investments of this size would be quickly swallowed up by transaction and human capital costs. Thus, we ourselves often struggle with the challenges of going even earlier stage with our investments.

The reality, of course, is that if we wish to build an impact investing industry that successfully delivers on the promise of bringing market-based solutions to disadvantaged populations, our success depends on our support for these early stage innovators. It is today's fledgling innovator who sets the stage for tomorrow's next great scalable innovation that can also produce strong financial returns.

## The Infrastructure Gap

It is encouraging to see infrastructure for the impact investing sector being built at the global level. Organizations such as the Global Impact Investing Network, the Aspen Network of Development Entrepreneurs, and the European Venture Philanthropy Network play key leadership roles in stewarding the impact investing industry at global and regional levels. The emergence of promising new entrepreneurs and entrepreneurial ventures, however, is also dependent upon a robust industry-specific infrastructure built at the national (and sometimes state) level.

For example, the previously mentioned 2011 McKinsey research on the medical technology sector in India, identified a host of infrastructure and ecosystem interventions that could collectively help increase the availability of medical services to the poor by millions of treatments per year. Such interventions included training institutions for medical device technicians, efforts to establish a national regulatory regime for medical devices, and the establishment of a center for excellence in social marketing for medical devices.

Many of these needs could be met by non-profit and low-profit organizations. Unfortunately, ready sources of funding for such efforts are hard to come by from impact and commercial investors who prioritize financial returns and/or measure their success on the basis of individual firm-level outputs rather than the development of industry sectors as a whole.



Innovators and industry-specific infrastructure firms often struggle to raise necessary funds and to get the human capital support often so critical to success. Indeed, capital appears to be thinnest precisely where it is needed the most: to prime the pump of innovation and deal flow.



## Where's the Money?

So, if there are yawning gaps in the capital curve for both innovators and infrastructure, then where is the capital likely to come from?

### Commercial Investors

The largest source of potential capital is in commercial capital markets, which represent trillions of dollars of investable assets. Commercial markets work quite well in allocating capital to businesses that the market believes will yield risk-adjusted financial returns. So-called “returns first” impact investors—those impact investors who prioritize returns above social impact—appear to many to be a subset of the commercial capital market. In most cases, commercial funds—whether they are impact investing funds or not—are tapped in later stages of market development, after specific innovations and business models are de-risked. Large scale commercial funds did not flow into microfinance, for example, until several decades after the generic microfinance model had been pioneered with the support of multilaterals and philanthropy. Commercial capital is thus of exceptional importance in the later stages of scaling up impact investing industry sectors (and it recently did this for microfinance); it is unlikely, however, to fill the gap in funding needed in for innovators and infrastructure.

### Established Foundations

US foundations alone deploy about \$47 billion per year (and sit on total assets of more than one about \$650 dollars). They are another major potential source of funding for the innovation cycle in impact investing. Indeed, many foundations have active Program Related Investment (PRI) initiatives, enabling them to invest in for-profit organizations delivering a positive social impact. However, notwithstanding the pioneering efforts of foundations such as Gates, Rockefeller, Hewlett, and Skoll, PRIs still represented only one percent of capital deployed by foundations in 2009. Moreover, most of this capital went to relatively low-risk debt instruments. Only five one hundredths of one percent of US foundation capital deployed went to equity PRIs, which represents the type of capital necessary to help fund innovators.

Substantially increasing direct foundation investments in “innovators” would also require a dramatic mindset shift—from seeing philanthropy’s primary role as addressing market failures to also embracing its potential to catalyze markets. Tapping foundation endowments, meanwhile, would require similarly fundamental shifts in endowment objectives and strategy. Given these obstacles, we think it is unlikely that foundations will dramatically increase their direct investments in early stage ventures. It is possible, of course, for foundations to provide funding to early stage impact investing funds, as Rockefeller did with Acumen. There is also great potential for foundations to provide funds for infrastructure and ecosystem work in industry sectors with strong social impact.

Already, existing initiatives such as the [AGRA Alliance for Agriculture in Africa](#) (supported by government and development institutions as well as foundations) and pioneering drug discovery for developing world diseases hold great promise in creating more opportunities for private sector innovators by increasing innovation and reducing risk. Large-scale, broad-based initiatives could be supplemented by more targeted short-term grants that benefit specific emergent business sectors and even firms.

### Development Institutions and Banks

Development institutions and banks could be excellent sources of funding for innovators in impact investing, particularly in emerging economies. They deploy billions of dollars every year with the explicit goal of combating poverty and contributing to economic growth in poor countries. However, incentive structures within these institutions are sometimes an obstacle. Employees of development banks are often rewarded for volume of capital deployed, which makes it difficult to support smaller, early-stage deals. And aid institutions often are not encouraged to take on high-risk equity investments. Indeed, development banks frequently need to justify their continued funding by demonstrating solid returns, making it relatively unattractive to pursue high-risk, early-stage investments.

Despite these incentive structures, however, we see a number of hopeful examples of development banks and agencies taking on

higher-risk, earlier-stage profiles. Programs like USAID's development innovation ventures, the [World Bank's development marketplace](#), and the [IDB's Multilateral Investment Fund \(MIF\)](#), and Opportunity for the Majority Initiative are steps in the right direction. We are also encouraged to see institutions such as the [International Finance Corporation](#), the [UK Department for International Development](#) (in cooperation with CDC) and the Dutch development bank, [FMO](#), take advantage of their equity windows to increase their involvement in early-stage investment. Development institutions and banks could also play a pivotal role in supporting the development of industry-specific infrastructure.

### **High Net Worth Individuals**

We see the increased involvement of high net worth individuals in impact investing as potentially catalytic to the sector. Individuals such as Pierre Omidyar, Vinod Khosla, Steve Case, Jeff Skoll, Sir Ronald Cohen, and others have deep entrepreneurial backgrounds. They not only embrace innovation and have a high risk tolerance; they are also quite willing to experiment with market-based and for-profit approaches to achieving social impact

We believe that individuals with similar approaches could have a transformative effect on the impact investing industry by investing in early-stage, high-growth ventures, and by funding industry-specific infrastructure to support these. We are eager to find creative ways to expand and support such efforts.

### **Directing Capital to the Right Places**

One of the great successes of the impact investing movement is that it has drawn attention to the fact that businesses can generate

The reality, of course, is that if we wish to build an impact investing industry that successfully delivers on the promise of bringing market-based solutions to disadvantaged populations, our success depends on our support for these early stage innovators. It is today's fledgling innovator who sets the stage for tomorrow's next great scalable innovation that can also produce strong financial returns.



tremendous social impact as well as financial return. There is ample capital out there; the key is tapping into appropriate sources for appropriate needs.

In so doing, investors will need to grapple with the complex and controversial topic of subsidy. Under what circumstances should investors consider using grant funds or concessional debt or equity in support of impact investing work? We turn to this topic in the next section.



## IV.

# “First, Do No Harm” The Use of Subsidies in Impact Investing



In Section III, we highlighted the biggest gaps in capital supply for impact investing. While money is flowing reasonably well to “scalars,” where investors expect high financial and social returns, money is less readily available for industry infrastructure and for early-stage innovators—especially in markets that serve the most disadvantaged.

One of the critical and contentious questions that impact investors often face—especially when investing in early-stage innovators—is about the role of subsidy. When, and in what circumstances, is subsidy appropriate?

### Investing in the Gray Space

Certain forms of subsidies are more controversial than others. It appears widely accepted, for example, that grant capital can and should be used to build industry infrastructure. Governments and foundations alike, for example, have regularly funded basic research in diverse fields such as agriculture and medicine.

What’s less clear is when and how financial subsidies—whether in the forms of grants or concessional debt or equity—should be given directly to for-profit innovators and scalars. The April 2012 Monitor report, [“From Blueprint to Scale: The Case for Philanthropy in Impact Investing”](#) describes the practice of giving grants to for-profit organizations as a

classic approach for building the pipeline of inclusive businesses in challenging markets. We applaud the exhortation to invest earlier in the innovation lifecycle. But we believe it is also important to conduct a thorough examination of the risks and benefits of subsidy in these situations. We would also point out that the appropriateness of subsidy is strongly influenced by the nature of the market being served: subsidies may be necessary to kick-start firms serving the very base of the economic pyramid, but are less essential—and potentially harmful—when directed at firms serving those with significant disposable income.

Finally, it’s extremely important to note that subsidy is not the only way to kick-start for-profit sector development, even for lower-income consumers. At Omidyar Network, our focus on developing deep sector and geographic expertise frequently leads us to price risk differently than generalist or geographically remote investors. A high percentage of our investments are in businesses that we believe—against conventional wisdom—have the potential to generate strong financial returns. Such willingness to question more conservative perceptions of risk is a major way that impact investors can accelerate the growth of new industry sectors. And in many cases, this approach can give impact investors a competitive advantage in finding promising profitable new business models that don’t necessarily require subsidy.



## The Risks of Firm Subsidy

Many strong market advocates cite the following potential risks of investing in a lower-returns business, whether with grants or with concessional for-profit capital:

### 1. Preventing a Level-Playing Field for Competition:

In well-functioning markets, return-seeking capital will flow to the firm that develops the best value proposition and business model for its target market. This tends to ensure that the firms that serve their customers best will be the ones that grow. If one provides subsidized capital or grant capital to one for-profit entity, but not all of its potential competitors, then one risks undermining the discipline of the market, thereby destroying rather than creating customer value.

We directly encountered this question in our recent work on mobile money. We know of several instances where funders have tried to kickstart the sector by giving a large grant to one leading mobile money player but not to its competitors. Is this the right thing to do? Does it distort the market and prevent robust competition? Are there better ways to use subsidy—such as funding multiple players or investing in sector-wide infrastructure? We have ongoing internal debates on this topic.

### 2. Limited Direct Scale:

Only highly profitable businesses, it is argued, will ultimately generate the cash flow and raise the capital necessary to scale up and have massive direct social impact. Low (or no) profit businesses may also be unable to attract the talent required to innovate and grow. Subsidizing a business with no prospects of operating at scale is therefore simply an inefficient use of capital.

### 3. Compromising the Promise of the Impact Investing Industry:

Impact investing will succeed only if investors are able to demonstrate strong investment acumen and the ability to work constructively with entrepreneurs to grow strongly profitable, scalable businesses. If impact investing becomes the domain of low financial and low scale expectations, many may question the

We would also point out that the appropriateness of subsidy is strongly influenced by the nature of the market being served: subsidies may be necessary to kick-start firms serving the very base of the economic pyramid, but are less essential—and potentially harmful—when directed at firms serving those with significant disposable income.



fundamental impact investing premise that businesses generating social impact also can earn strong returns.

## The Positive Uses of Firm Subsidy

Of course, there are also circumstances in which the potential benefits of directly subsidizing a for-profit business may outweigh the risks. The following are counter-arguments to the risks described above:

### 1. Spurring Market Development

It is all fine and well to complain that subsidies may distort markets, but what if there is no market to distort? In some cases, subsidies are going to firms that are trying to create an entire new market and are willing to take risks that no other entity is willing to take. In general, the more disadvantaged the population being served, the lower the prospects for profitability and the lower the risk that a subsidy will be market distorting.

### 2. Catalyzing Other Models of Scale:


While tapping commercial capital markets may make it easier for firms to scale and directly touch millions of customers, it is not the only way for for-profit organizations to

contribute to impact at scale. As noted in the previous blog post, some firms will have their biggest impact by contributing to indirect scale. These firms can pioneer an innovative model that will be improved by subsequent actors who may indeed be able to generate strong returns. There are also firms that generate a low return but provide critical industry infrastructure. Investors who consider both sector value creation AND firm value creation, may find it catalytic to invest in these kinds of businesses.

Additionally, it is important to note that different firms have different capital requirements. Some “low-capital-intensive” firms, particularly those that make use of technologies such as the Internet and mobile, can scale on their own without having to tap commercial capital markets.

### 3. Creating Pipeline for the Impact Investing Industry

It's worth noting that many of the firms having the biggest impact on disadvantaged populations have indeed benefitted from some form of subsidy. According to the Monitor group, most of the businesses serving [the base of the pyramid in India benefitted from subsidy in their early years](#). M-Pesa, the widely recognized innovator in mobile payments, was launched with a grant from DFID, the UK development agency. And microfinance, which remains the single most prominent example of a high social impact sector serving primarily the poor, benefitted from more than a billion dollars of subsidy



Generally speaking, the biggest determinants of whether we will consider below market returns tends to be the income level and size of the market that the entrepreneur is trying to serve.

before reaching commercial viability. In sum, in certain markets, there may be no chance of making impact investing a high returns business without first using subsidies to prime the innovation pump.

We would not rule out the possibility of a fourth scenario in which a socially impactful industry sector has a steady state in which there are medium returns and high impact. This, too, remains a subject for internal debate and perhaps fodder for a future blog post.

### First, Do No Harm

At Omidyar Network, our ability to deploy all types of capital, from grants to commercial investment capital—and everything in between—has caused us to think carefully about what type of capital to use in which situations. We are reticent to invest in low returns businesses, lest that lead us down the path toward limited scale, sloppy investing, diminished expectations, and potential market distortion. Nevertheless, we do feel that there are instances when it is worthwhile to invest in a business even though it may be unlikely to generate a strong financial return. There really is no simplistic “yes” or “no” answer, but rather a complicated and nuanced set of conditions under which different types of investments can play a complementary role in sparking sectors. We think the impact investing sector would be well served if it moved beyond the simple “is subsidy good or bad” formulation and toward a more nuanced, inclusive and ultimately more impactful approach.

Generally speaking, the biggest determinants of whether we will consider below market returns tends to be the income level and size of the market that the entrepreneur is trying to serve. For example, in 2008, we made a concessionary equity investment in BRAC to deliver microfinance services in Liberia and Sierra Leone because they were serving a small, extremely poor, war-torn population. (We also gave a grant to their sister NGO that gives livelihood training to poor rural women to enable them to take advantage of the small loans they receive.) Not surprisingly, organizations providing goods or services

to the extreme poor are much more likely to require subsidy than those serving the next level up.

Market distortion tends to be a bigger risk in large markets, with multiple players, serving relatively affluent populations. We find that impact investors can sometimes lump the vast majority of developing world customers into a very broad definition of “base of the pyramid” without appreciating the vast differences in disposable income and purchasing habits across segments. (There is an excellent overview of segmenting the [BOP](#) by Harvard Business School Professor Michael Chu.)

In sum, we believe that impact investors should adopt a “do no harm” credo with respect to the use of subsidies. Before subsidizing a for-profit firm with grants or concessional debt or equity, impact investors should ask themselves several questions:

1. Am I slanting the competitive playing field by favoring one firm over another? Even if there is only one incumbent, will a large grant dissuade others from entering the market?
2. If I do not expect market rates of return on my investment, do I believe that this firm can meet at least one of the following conditions:
  - a. Scale on its own or with additional grant funding without needing follow-on rounds of commercial financing;
  - b. Eventually refine its business model, so that it can tap commercial capital down the road;
  - c. Create a significant demonstration effect, thereby advancing or even catalyzing an entire sector;
  - d. Provide an important public good for the industry as a whole.

In sum, we believe that impact investors should adopt a “do no harm” credo with respect to the use of subsidies



Innovative firms, whether supported by subsidy or not, play a central role in sparking entire new sectors for social change. But they do not always control their own destiny. Of course, government and politics have a critical role to play. A firm can win in the marketplace and still fail if it does not carefully consider the impact that it has—not only on its customers but also on entrenched economic interests and on the politicians who consider themselves to be advocates of the disadvantaged. And government also can play a hugely catalytic effect in creating entire new sectors. We turn to this issue in the next section.



V.

## Government Matters



To date, much of the discussion about policy for impact investing has been about specific tools, such as special purpose legal vehicles (e.g., the benefit corporation), or tax incentives for investors. While this is important, we would suggest there is a more urgent need—to align interests between those who are trying to serve disadvantaged populations from a business perspective and those in government who feel they represent the disadvantaged.

### Political Risk and Vulnerability

The microfinance crisis in [Andhra Pradesh](#) and the [No Pay movement in Nicaragua](#) were not random anomalies. Explosive questions about appropriate pricing and quality of service are central to all for-profit efforts serving the disadvantaged. So, too, are questions about political interests, threatened incumbent players, and colliding ideologies.

Impact investors cannot afford to ignore critical political considerations. Enlightened politicians and policymakers have the potential to dramatically speed up the rate at which an industry can scale to responsibly serve hundreds of millions. Conversely, when impact investors fail to align with policymakers, we will find ourselves at risk of double jeopardy. We can fail because the companies we invest in may have a hard time growing in the most challenging of markets. Or we can fail because these same companies may

eventually be seen as too successful and profitable—inviting a powerful and potentially destructive backlash from public opinion, threatened incumbent commercial interests and/or politicians.

### The Role of Government

Governments have numerous powerful levers at their disposal to accelerate new industries for impact. Among the most important policy imperatives are: ensuring fair and robust competition; establishing appropriate regulation; and promoting entrepreneurship.

#### 1. Ensuring Robust Competition

In both India and Mexico, a significant percentage of the population lives in poverty. And in both countries, poor people use mobile phones for everything from banking services to getting health advice when they're too far from a hospital. But whereas in India, the typical mobile phone user pays less than a cent per minute of airtime, in Mexico, this same service costs 27 cents per minute. Why this difference?

In the late 1990s, the Indian government deliberately adopted policies (including a major decrease in licensing fees) to move the mobile market from a duopoly to a market in which 14 major players actively compete. As a result, prices have dropped and demand widened—leading to far greater inclusion of

the disenfranchised. In Mexico, meanwhile, Telcel controls about 70 percent of the mobile telephony market and has been able to successfully maintain a situation of limited competition. According to a [January 2012 OECD report](#), Mexican consumers are being over-charged by \$US 13.4 billion a year for phone and Internet services. Monopolistic or oligopolistic players not only charge higher rates, of course, they also tend to hinder innovation.

The importance of competition is also underscored by the experience in microfinance. Intense competition—rather than interest rate caps or government fiat—has been one of the single most important drivers of declining interest rates and improving customer service, according to a [2006 CGAP study](#).

## 2. Establishing Appropriate Regulation

Policymakers must be proactive in ensuring appropriate consumer protections for the poor and disadvantaged consumers. But they have a wider variety of tools to do so than one might frequently assume. In microfinance, for example, successful countries like Bolivia and Peru have strict regulations to ensure the financial solvency and responsible credit underwriting methodologies of lending institutions. But regulation should not be overly onerous and should encourage innovation rather than protect incumbent players. Significantly, many countries permitted MFIs to provide savings as well as credit products, allowing MFIs to serve customers better, even while diversifying their revenue base and reducing reliance on interest-charging credit products. Many industry [observers](#) note that the Indian governments refusal to allow MFIs to accept deposits contributed to the MFIs obsession with rapid credit expansion and client over-indebtedness, which were contributing factors to the crisis in Andhra Pradesh.

Mobile payments is another sector in which government policy can either accelerate or hinder market development. When considering the enormous utility and growth potential of mobile payments, most governments have legitimate concerns about money laundering and less high-minded concerns about the business risks that such innovations pose for the frequently coddled banking sector. In Kenya, the government has worked

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with M-Pesa, the popular mobile payments provider, to establish limits on the size of money transfers, thereby substantially reducing money laundering risk. M-Pesa has been an enormous success, and now serves more than 70 percent of Kenyan adults and handles the equivalent of 25 percent of Kenyan GDP. Unfortunately, mobile payments has been far less successful in many countries where vested interests are stronger. In too many countries, regulators have taken a much more restrictive approach and been less resourceful in developing appropriate solutions to enable the safe and reliable mobile money transfers.

## 3. Promoting Entrepreneurship

New sectors are only as good as the entrepreneurs and teams that develop innovative products and services. There's a lot that governments can do to ensure the quality and vibrancy of entrepreneurial activity.

Rwanda, for example, has achieved an impressive 8.4 percent growth rate over the past decade. Part of this is due to reforms initiated by President Kagame that have made it easier to start businesses, register property, protect investors, and access credit. Kagame's approach was bottom-up rather than top-down; he saw entrepreneurs as directly responsible for building the economy, and devised policies to get out of their way. He also promoted specific sectors and facilitated the creation of relevant infrastructure to help them scale.



With a similar philosophy, Omidyar Network recently worked with the Government of India on a series of recommendations to build the country's entrepreneurial ecosystem. The recently released [report](#) highlights a variety of proactive steps the government can take—including scaling up venture incubation facilities, as well as providing appropriate regulations around capital gains to encourage easier exits for angel and early-stage investors. An excellent overview on the ways in which government can help drive a more entrepreneurial environment is available [here](#).

Philanthropists and not-for-profits also play a critical role in creating more vibrant entrepreneurial ecosystems. [Endeavor](#), a global not-for-profit headquartered in New York City, for example, seeks to catalyze long term economic growth by selecting, mentoring, and accelerating high impact entrepreneurs in 13 countries around the world. Among other things, Endeavor is cultivating the creation of a powerful network of entrepreneurs: entrepreneurs who are not only successful in their own right, but entrepreneurs who—through collaboration, mentoring, and investing—are creating a network and an ecosystem that can have a massive multiplier effect on country-level innovation. Indeed, Endeavor's experience suggests that a robust network of entrepreneurs and mentors can overcome even challenging macroeconomic and policy environments. Endeavor's work in fostering an entrepreneurial network in Argentina has been particularly impressive, as highlighted in this [short video](#).

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Politics and policy are but two factors that fundamentally shape the trajectory of new sectors. Ultimately, success is best achieved when supportive politicians and policies are married with entrepreneurs and a diverse set of investors who are deeply committed to innovation and sector level change. Getting this formula right can mean the difference between impacting hundreds and hundreds of millions of lives. In our next and final section, we turn to the question of what is at stake at the critical junctures of market development: how do markets actually scale and what are the points at which entrepreneurship, different kinds of capital, and policy come together to make meaningful difference in the lives of millions of people.



## VI.

# Achieving Take-Off



It is telling that so many in the impact investing sector—including us in this discussion paper—consistently fall back on microfinance as the example of successful impact investing for the disadvantaged. Microfinance, despite recent controversy and misgivings, has indeed reached massive scale—an estimated 200 million people. But microfinance took three decades to attain this scale, and it still reaches a modest percentage of those in need.

The contrast to mobile telephony—a purely commercial innovation that has fundamentally improved the lives of the poor—is dramatic. Although the first commercial mobile cellular services were established in 1978 (around the time of the emergence of microfinance), the number of mobile accounts in the developing world soared from less than five percent of the population in 2000 to more than 70 percent (more than 4.5 billion people) today. Although the dynamics and challenges of microfinance and mobile telephony are quite different, we must ask ourselves how we can create more innovations that achieve the kind of breadth and rapid expansion that mobile telephony experienced.

In this paper, we've argued that it is both possible, and urgently necessary, for impact investors to head in this direction. But success will require a shift from current practice. Instead of cherry-picking investments in individual enterprises that will yield high return and high social impact, we need to commit to

“priming the pump” to encourage the growth of new industry sectors. We'll need to take more diverse risks (not just traditional firm-level business risks, but sector risks), and deploy a variety of capital types (from grants to a variety of high-risk for-profit investments)—to get early-stage innovators off the ground, and support the infrastructure that accelerates their success. This will also frequently require deploying political and policy capital—types of capital not often discussed in the impact investing arena. In order to promote the delivery of high quality products at reasonable prices, policymakers may need to confront vested interests to promote competitive markets that protect the interests of consumers.

We conclude this discussion paper by illustrating why these actions are of such great importance to billions of people.

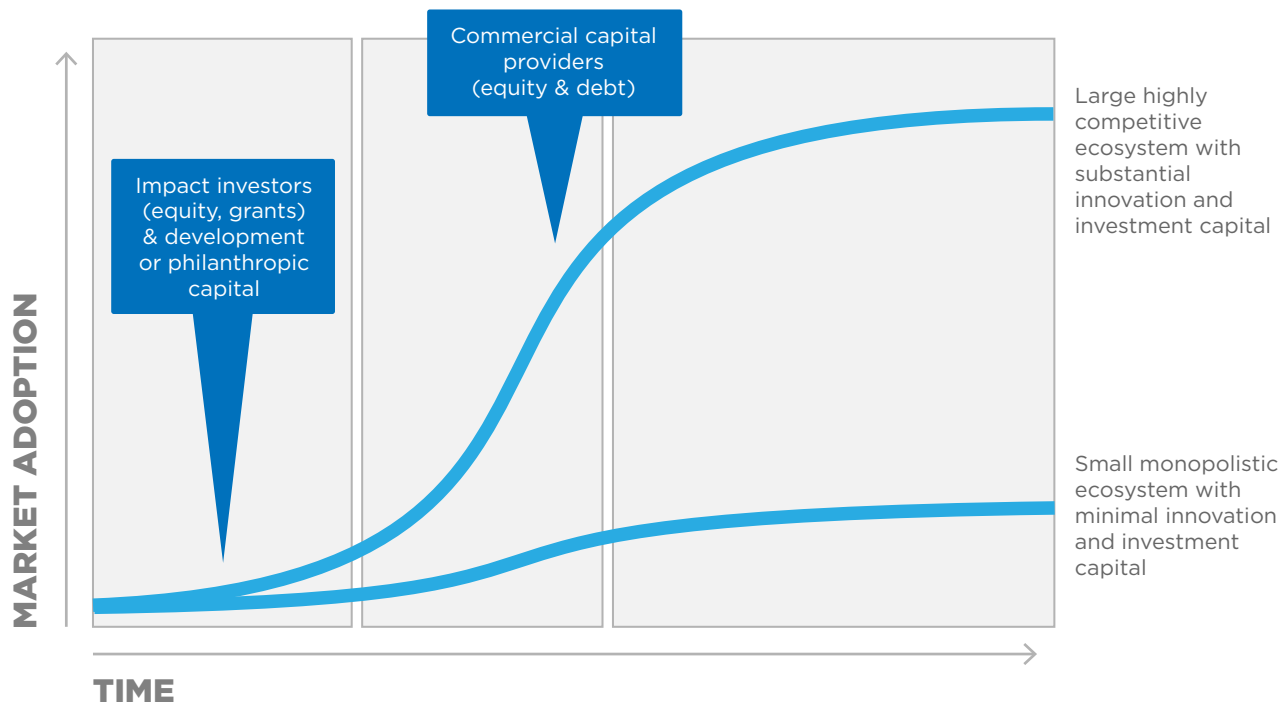
### Altering the S-Curve

For years, analysts of commercial markets have used the so-called “S-curve” to describe the adoption of a new innovation across a society over time—from early adoption, through rapid growth and to maturity. Typically, the adoption of a new innovation happens slowly in the initial phases, then increases rapidly for a number of years before beginning to slow down to where a product reaches what appears to be a long-term saturation point.

The S-curve shows us in stark terms how seemingly small changes can dramatically impact millions of lives. Bringing forward the year of “take-off point or accelerating the rate of adoption, even by a small amount, can yield extraordinary leverage in terms of the number of lives impacted. These kinds of interventions can make an exceptional difference in the developing world, where very few market ecosystems develop rapidly and seamlessly.

The bottom curve in the chart above—with limited scale and very slow adoption of a new product—unfortunately represents the status quo for most sectors serving the disadvantaged. We have far too many examples of sectors captured by one or two monopolistic players that prevent further growth and innovation. In many slums, for example, water is provided by local gang lords, who will prevent anyone else from supplying water or demand graft in exchange for market access. The same situation holds for moneylenders that operate in remote villages where banks are absent. Such situations tragically force poor customers to pay high prices for low-quality products, limiting their choices and, ultimately, their economic mobility.

But success will require a shift from current practice. Instead of cherry-picking investments in individual enterprises that will yield high return and high social impact, we need to commit to “priming the pump” to encourage the growth of new industry sectors





## Emerging Sectors

Luckily, the picture is not entirely bleak. We are beginning to see the emergence of sectors that have a strong chance of beating the typical “lazy S-curve. The solar lighting sector is one robust contender. Starting around 2007, early stage impact investors helped companies like d.light test production of low-cost, environmentally friendly lighting that could serve the 1.4 billion poor people currently without access to grid electricity. Over time, a number of competitors have entered the field, driving prices down to below the dollars for simple lanterns and increasing the quality and diversity of products offered. The growth of the solar lighting sector has in turn created secondary ecosystems, further helping to accelerate the market. A new crop of companies like [M-KOPA](#) and [Eight19](#) have developed creative financing schemes enabling poor customers to afford lanterns by spreading out the schedule of payments.

Industry-specific government policy has played a huge role for the solar home products—both for good and ill. In places like India, solar lantern producers have had a harder time competing because of government subsidies for kerosene—a well-intentioned policy that unfortunately keeps the poor dependent on an environmentally hazardous and less efficient energy source. By contrast, in Bangladesh, the government has greatly accelerated the market for home solar systems by providing supportive financing terms. These financing plans have helped some 750,000 remote households and shops to access a suite of solar products that enable children to study at night and businesses to extend their hours past dark. Over 30,000 solar home systems are being installed every month in rural Bangladesh.

We also see great promise in the affordable private education sector. In the early days, commercial investors were skeptical

that private schools could deliver affordable, high quality education to poor people in Kenya. But Bridge Academies has tested and refined a highly innovative “school in a box” model, delivering high quality instruction, and expanding to nearly 82 locations. In the process, they’ve started to receive attention from serious commercial investors. Not only will Bridge itself likely be able to expand operations to neighboring East African countries—we also expect copycat businesses to emerge, thus further accelerating the growth of the sector and delivering vastly improved educational opportunities to millions of children.

As previously mentioned, the success of Kenya’s MPesa mobile payment system, also portends an exciting new future for mobile payments. The success of mobile payments would not only create more efficient, safe and affordable payments for millions. It would also foster additional new sectors in related mobile services and mobile commerce, thus further enhancing opportunity and spawning economic growth.

Success for critical industry sectors is far from guaranteed. Any number of potential pitfalls—from political sensitivities to marketing challenges to local economic shocks—could slow down or halt the rate of growth. And even if these sectors are successful, we’ll be faced with a number of new and challenging questions. For example, having developed an innovative model of affordable education for the poor, should firms such as Bridge open-source their learning to encourage replication, or is it preferable keep trade secrets in order to maintain competitive advantage? How does corporate ownership and governance shape a firm’s focus on critical issues such as an adherence to a social mission? Does a firm even need an explicit social mission to have positive social impact? How do answers to these questions evolve when firms begin to tap commercial capital markets?

## Getting to Take-Off

We do not pretend to have all the answers. We simply know that even small steps in the direction of bending the S-curve can alter the lives of millions. If we had worked earlier with policymakers in Andhra Pradesh to ensure healthy competition and reasonable consumer protection, millions more people would now have access to financial services in India. Or recall our earlier examples about medical technology for the base of the pyramid in India. Accelerating the point of takeoff for medical device industries by three to four years would mean an additional two billion treatments per year for the poor—which could mean the difference between life and death for many

The impact investing sector, while still in its infancy, has made remarkable progress in building awareness that business can generate a positive social impact. Although individual firms remain the essential innovators and building blocks of social change, they are means to a broader end of creating innovations that can touch the lives of hundreds of millions. It is time now to evolve the conversation, and our resource commitments in the direction of sparking, nurturing, and scaling these new industry sectors that are the true promise of the impact investing industry.

What is readily apparent to us is that no one organization, or one type of organization, can do this alone. Success does not depend upon perfect coordination or a grand plan. After all, we are talking about innovation, which requires experimentation, learning, and serendipity. But success does require a determined, thoughtful, and frequently collaborative effort by those who believe that the power of markets and the inspiration of entrepreneurs can be tapped to create opportunity and a brighter future for billions.



# About Omidyar Network



## OMIDYAR NETWORK™

Omidyar Network is a philanthropic investment firm dedicated to harnessing the power of markets to create opportunity for people to improve their lives. Established in 2004 by eBay founder Pierre Omidyar and his wife Pam, the organization invests in and helps scale innovative organizations to catalyze economic and social change. To date, Omidyar Network has committed more than \$550 million to for-profit companies and non-profit organizations that foster economic advancement and encourage individual participation across multiple investment areas, including financial inclusion, entrepreneurship, property rights, consumer internet and mobile, and government transparency.

For more information, please visit: [www.omidyar.com](http://www.omidyar.com)

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