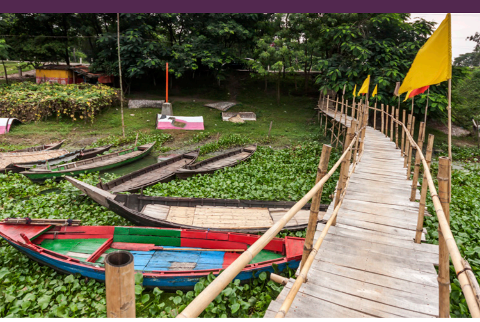
PAKISTAN

THE LANDSCAPE FOR IMPACT INVESTING IN SOUTH ASIA

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



Dalberg

GIIN
GLOBAL IMPACT INVESTING NETWORK

LIST OF COMMON ACRONYMS

ADB | Asian Development Bank

AIF | Alternative Investment Funds

BoP | Base of the Pyramid

BRICS | Brazil, Russia, India, China, South Africa

CA | Chartered Accountancy

CIIE | Centre for Innovation, Incubation and Entrepreneurship

CGTMSE | Credit Guarantee Fund Trust for Micro & Small Enterprises (India)

CSR | Corporate Social Responsibility

DFI | Development Finance Institution

DFID | Department for International Development

FIL | Foreign Investment Law

FDI | Foreign Direct Investment

GAAR | General Anti-Avoidance Rules (India)

GIZ | Gesellschaft für Internationale Zusammenarbeit (German Agency for International Cooperation)

HDI | Human Development Index

HNWI | High Net-Worth Individual

HR | Human Resources

ICT | Information and Communication Technology

IFC | International Finance Corporation

IFI | International Financial Institution

IE | Impact Enterprise

IIC | Impact Investors' Council (India)

IMF | International Monetary Fund

LP | Limited Partner

LTTE | Liberation Tigers of Tamil Eelam

MDG | Millennium Development Goal

MEB | Myanmar Economic Bank

MFI | Microfinance Institution

MFTB | Myanmar Foreign Trade Bank

MNC | Multinational Corporation

MICB | Myanmar Investment and Commercial Bank

NABARD | National Bank for Agriculture and Rural Development

NASE | National Association of Social Enterprises (India)

NEDA | National Enterprise Development Authority (Sri Lanka)

OPIC | Overseas Private Investment Corporation

PE | Private Equity

PM | Prime Minister

PPP | Purchasing Power Parity

RBI | Reserve Bank of India

SEBI | Securities and Exchange Board of India

SIB | Social Impact Bond

SIDBI | Small Industries Development Bank of India

SME | Small or Medium Enterprise

SMED | Small and Medium Enterprise Development (Sri Lanka)

SVF | Social Venture Fund

VC | Venture Capital

WHO | World Health Organization

TABLE OF CONTENTS

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

ABOUT THIS REPORT

The objective of this study is to develop an understanding of the status of the impact investing markets in six countries in South Asia—Bangladesh, India, Myanmar, Nepal, Pakistan, and Sri Lanka. The full report includes an introduction and a chapter for each country. This research is intended to serve as a critical input to future investments and engagement to build and grow these markets. The key themes explored include the current status and trends in terms of the types of active investors, capital deployment, opportunities for and challenges to investing, the demand for impact capital, challenges to accessing capital and opportunities for enterprise growth, and the vibrancy and scale of the supportive ecosystem for the industry.

Introduction

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

South Asia is home to more than 1.6 billion people and has experienced dramatic economic growth over the last decade. However, this rapid growth, while changing some economies dramatically, has been uneven between and within countries; about a quarter of the region's population continues to live on less than USD 1.25 per day[1] and large population segments lack access to quality social services, finance, energy, and infrastructure as well as to affordable consumer products. The opportunity for impact through the deployment of capital into organizations and enterprises that increase incomes, create jobs, and provide access to essential services is significant, and the status of the impact investing industries in these countries is worthy of attention.

Who is an impact investor?

Impact investments are "investments made in companies, organizations, and funds with the intention to generate social and environmental impact alongside a financial return."[2]

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

- Expectation of a financial return that can range from the return of capital to risk-adjusted market-rate returns and that can be derived from investments in a range of asset classes.

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1 *Weighted average calculated with the latest country data (2010–2012) from World Development Indicators, The World Bank; Myanmar figures are not included in the weighted average as this indicator is not available for Myanmar.*

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

- Intent to generate a positive social and/or environmental impact through investments. For example, investors may seek to use investments to increase access to basic services or invest in solutions aimed at mitigating the negative effects of climate change.

- Commitment of the investor to measure the social/environmental performance of the underlying investments.

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

While the central goal of this study is to map the current landscape of the impact investing activity, there is also significant investment activity on the periphery of impact investing that is interesting to explore. In particular, we consider the following two types of investment activity:

a. Investments in businesses at the businesses serving BoP populations by investors who have may not have explicit impact intention

b. Investments where there is some intention to have social and/or environmental impact, but this impact is assumed to occur as a by-product and is not measured in any meaningful way

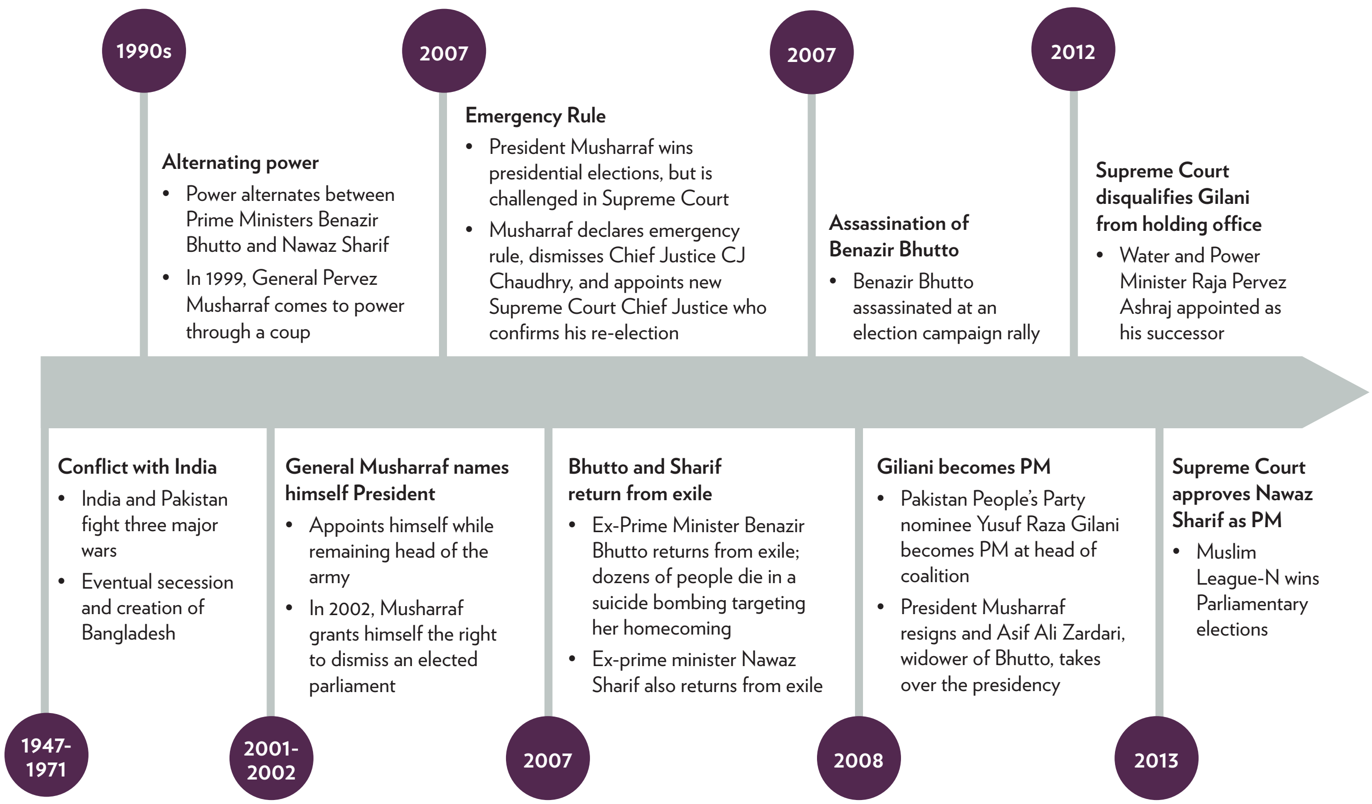
Such investment activity is also important for an analysis conducted to gain a better understanding of the broader opportunity landscape for impact investing going forward. When a section in the report focuses particularly on the investment activity in this peripheral region, we will explicitly refer to these as "impact-related" investments, thereby clearly differentiating them from "impact investing." (Please note that we are using these labels purely for the ease of reference and do not intend the names to imply any subjective judgment on the nature of an investor's investment activity or approach.)

COUNTRY CONTEXT

Overview

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

FIGURE 1: TIMELINE OF PAKISTAN'S POLITICAL HISTORY



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

In addition to political instability, the most significant deterrent for investors is the perceived insecurity or the volatility of the security situation in the country. Pakistan has been marred by terrorist attacks and sectarian violence. Despite government attempts to fight terrorism, threats remain high. Since 2001, terrorism inside Pakistan has increased twofold, where in addition to sectarian violence, Pakistan has had to combat the threat of Taliban militants and the Al-Qaeda. According to President Zardari, between 2001 and 2011, militant attacks killed 35,000 people in Pakistan (including 5,000 law enforcement personnel) and caused material damage worth USD 67 billion.[3] According to the South Asia Terrorism Portal (SATP) database, between 2003 and September 2014, there were 18,389 civilian and 5,917 security force personnel fatalities due to terrorist violence.[4] These attacks have targeted both local and foreign interests, including physical and human resources for the United States' "war on terror," establishments frequented by westerners, direct interests of the Pakistani army, numerous prominent Pakistani politicians (some of whom were assassinated), key infrastructure (including airports and courts), and various ethnic and religious minority groups.

GDP growth and drivers of foreign direct investment (FDI)

Security concerns greatly undermine investor confidence and deployment of foreign capital into Pakistan; investors have reacted strongly to significant changes in the political environment (see Figure 2). For instance, a rapidly worsening security situation in 2007 and 2008 (imposition of emergency rule and the siege of a major mosque by a terrorist group) preceded a dramatic decrease in FDI inflows in 2008 and 2009.

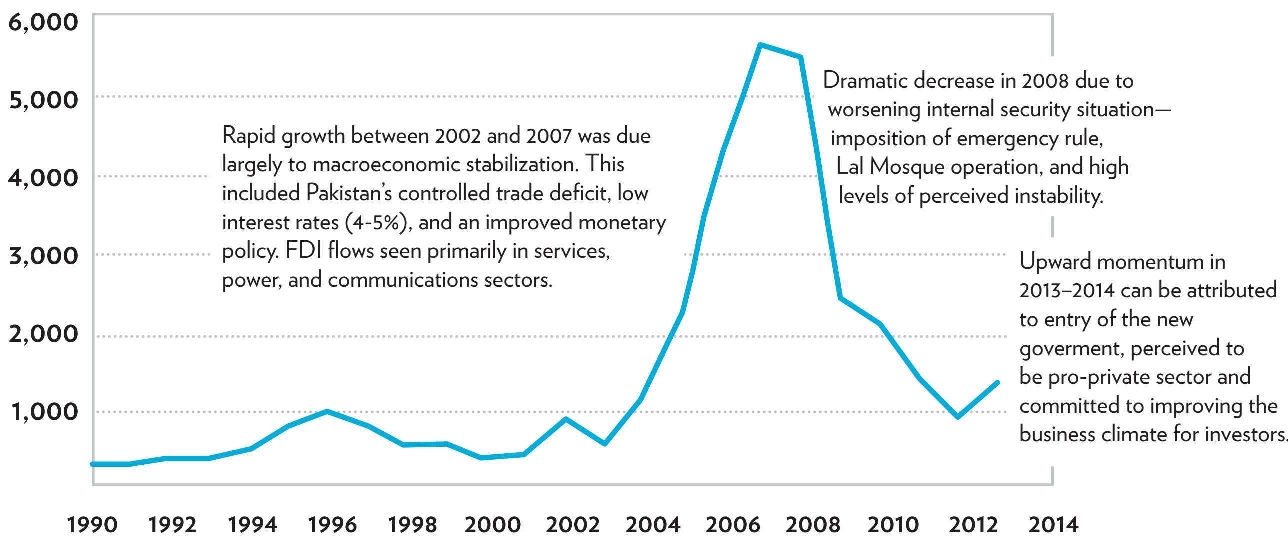
Although security concerns remain an issue, the introduction of pro-business and private sector measures as of 2012 under Prime Minister Sharif's government have resulted in increased FDI in the country. The new government has taken several measures to improve the ease of doing business in Pakistan, particularly with respect to investor protection and starting a business. Moreover, the government has launched fiscal and structural reforms (supported by the International Monetary Fund (IMF)) to address macroeconomic challenges and energy shortages, and to steer the economy towards faster and more sustainable growth[5] (refer to the "*Enabling impact investing: The ecosystem*" section for more details on the regulatory environment).

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

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

5 *ADB,* Asian Development Outlook 2014*, Manila, 2014.*

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

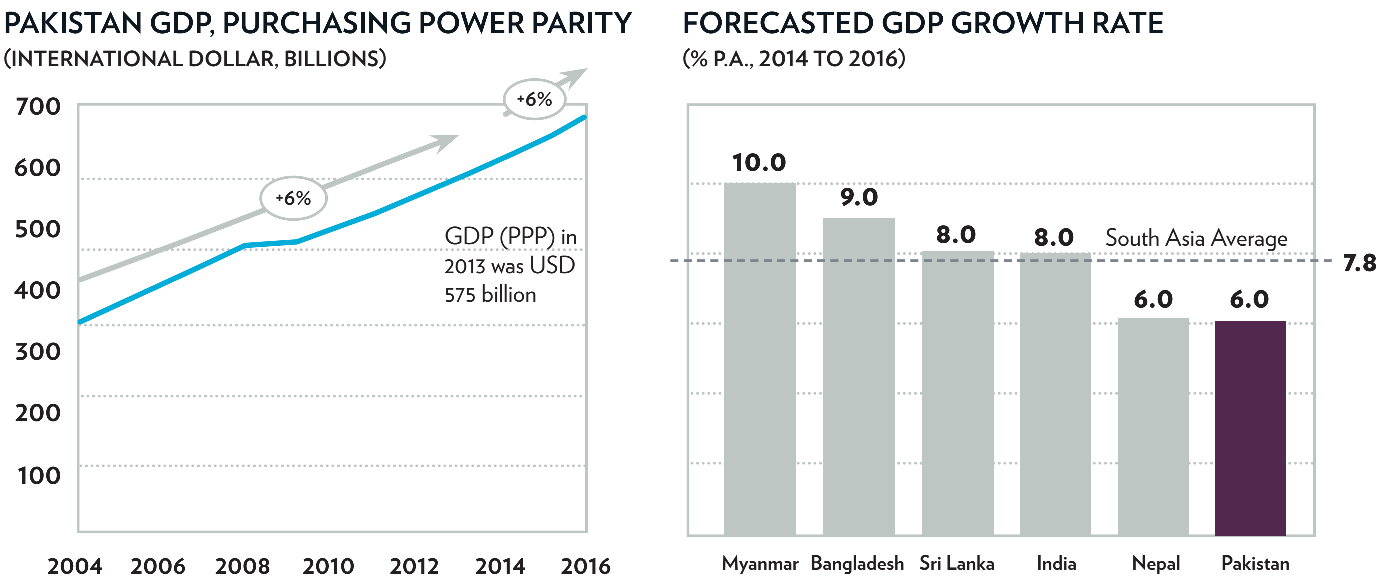


Source: World Development Indicators, The World Bank

Pakistan's forecasted GDP growth rate is predicted to be one of the lowest in the region. The key drivers of Pakistan's low projected growth are continued security concerns and the need for structural reforms in the areas of energy, taxation, and state-owned enterprises.[6] Accelerating growth will be challenging without improvements in the security situation and without addressing these regulatory and infrastructural challenges.

6 ADB, *Asian Development Outlook 2014, Manila, 2014.*

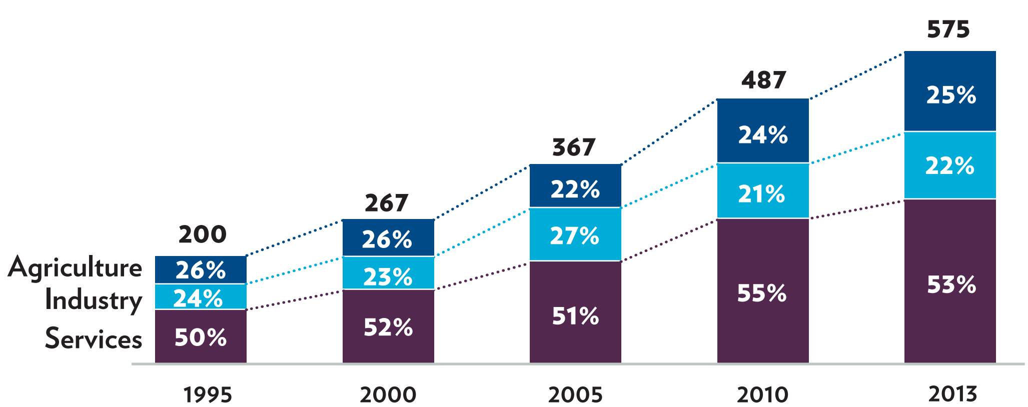
FIGURE 3: PAKISTAN GDP (PPP) OVER TIME AND FORECASTED 2015 GDP GROWTH RATE FOR THE REGION



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

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

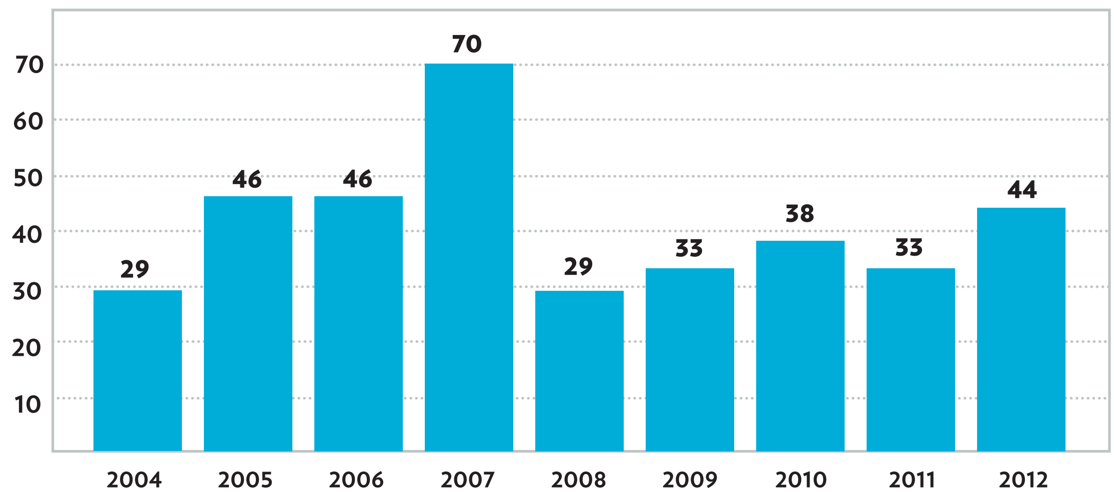
FIGURE 4: SECTOR CONTRIBUTION TO GROWTH AS PERCENTAGE OF GDP (PPP, INTERNATIONAL DOLLAR, BILLIONS)



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

In addition to GDP growth, the capital markets are slowly recovering after a drastic decline in 2008. Pakistan has three stock exchanges, namely Karachi, Islamabad, and Lahore. Market capitalization grew from USD 33 billion to USD 44 billion in 2012[7] (See Figure 5). Moreover, despite violence and a worsening security situation, there was overall growth in market capitalization between 2004 and 2012 due to a wide range of economic reforms launched in 2000, including fiscal adjustment, privatization of energy, banking sector reforms, and trade reforms. In addition, low interest rates, high liquidity, and strong external demand helped Pakistan's growth. Moreover, concessional external assistance and debt restructuring (including that from the World Bank) played a significant role as did increased support provided by the US post-September 2011.[8]

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



Source: World Bank Development Indicators

Key constraints in Pakistan

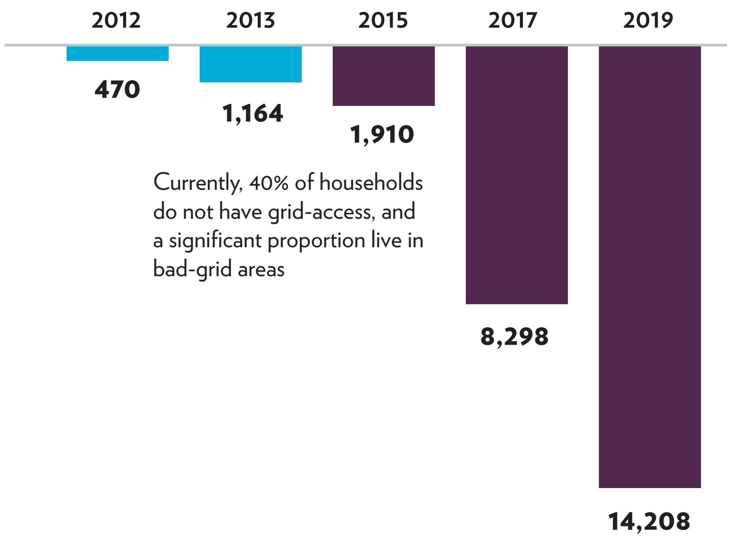
Energy shortages, in addition to security concerns, remain one of the most significant challenges to investment. Currently, more than 30% of all households are un-electrified,[9] while a significant proportion of Pakistan's population is under-electrified. Access to energy is a particular concern for the manufacturing industry for which consistent, reliable, and affordable power is a key driver of competitiveness. Investors report low interest in heavy manufacturing sectors due to the high costs of such access to energy.

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

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

9 *World Development Indicators, The World Bank.*

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



Sources: Oracle Coal Fields, Country Overview

Given the projected deficit, the government and the private sector are now trying to directly address the access to energy challenges. The government is undertaking the construction of more power plants, using both renewable (e.g., wind and hydro-power) and non-renewable energy sources, in addition to providing cash and bonds[10] to independent power producers to enable them to clear their outstanding debts and generate additional power.[11] Moreover, given the market opportunity to serve consumers in off-grid and under-electrified regions, there is an increasing interest in the development of enterprise models to serve the energy needs of these areas.[12]

Overall, despite concerns about security challenges and energy shortages, Pakistan's large population, growing middle class, and increasingly favorable regulatory investment environment remain strong foundations for attracting investors. The large domestic market creates a strong demand and opportunity and is expected to grow with the expansion of the consumer class. Similarly, the regulatory environment has been improving since 2000. For example, today, fewer approvals, permits, and licenses are required from several different government entities to launch a business in Pakistan.[13] Overall, while Pakistan's World Bank "ease of doing business" rank of 128 is below that of Sri Lanka's (99) and Nepal's (108), Pakistan scores higher than both India (142) and Bangladesh (173).

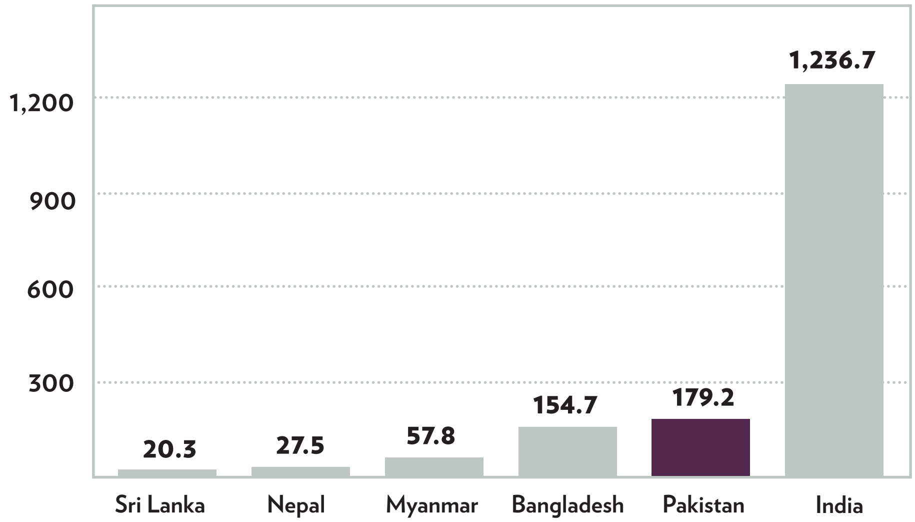
10 *The Diplomat,* Pakistan's energy crisis*, 2013.*

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

12 *Dalberg, Stakeholder interviews*

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

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



Source: World Bank Development Indicators

Despite this relative regulatory strength, public service provision in Pakistan remains poor, as evidenced by its low performance on key social indicators. Pakistan's human development index score of 0.52 is below the South Asia average of 0.56,[14] life expectancy at birth is relatively low at 65.7 years,[15] and infant mortality is high at 69 per 1000 live births,[16] which are all indicative of a weak healthcare system.[17] Similarly, in the education sector, with almost 5.5 million children that are out of school, Pakistan has the second highest number of out-of-school children in the world, after Nigeria.[18] Literacy rates are low and skewed by gender: 50% for women and 69% for men.[19] According to UNESCO's 2014 Global Monitoring Report, Pakistan is among the 21 countries facing an extensive "learning crisis" due to academic performance, literacy, enrolment, and dropout rates.[20]

INVESTING IN PAKISTAN: THE SUPPLY SIDE

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

15 *UDDP,* Human development index, *2013 (2012 data).*

16 *UNICEF,* Pakistan statistics, basic indicators, *2012.*

17 *World Development Indicators, The World Bank (2013)*

18 *UNESCO, "Teaching and learning: Achieving quality for all,"* EFA Global Monitoring Report, *2014.*

19 *World Economic Forum,* The global gender gap report, *2013.*

20 *Op Cit. UNESCO,* EFA global monitoring report, *2014.*

The broad impact capital market in Pakistan

In spite of the perceptions of extreme volatility and insecurity, Pakistan has one of the largest impact investment landscapes in the region. More than USD 1.9 billion has been deployed into Pakistan by impact investors across a range of sectors and using a range of instruments, dwarfing capital deployed in all other countries in South Asia except in India.

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

The impact investing space in Pakistan is diverse, with a range of different actors. Figure 8 provides an overview of the landscape of actors, including both impact investors and investors in related activities but without an explicit impact intention or commitment to measure impact.

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

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

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

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

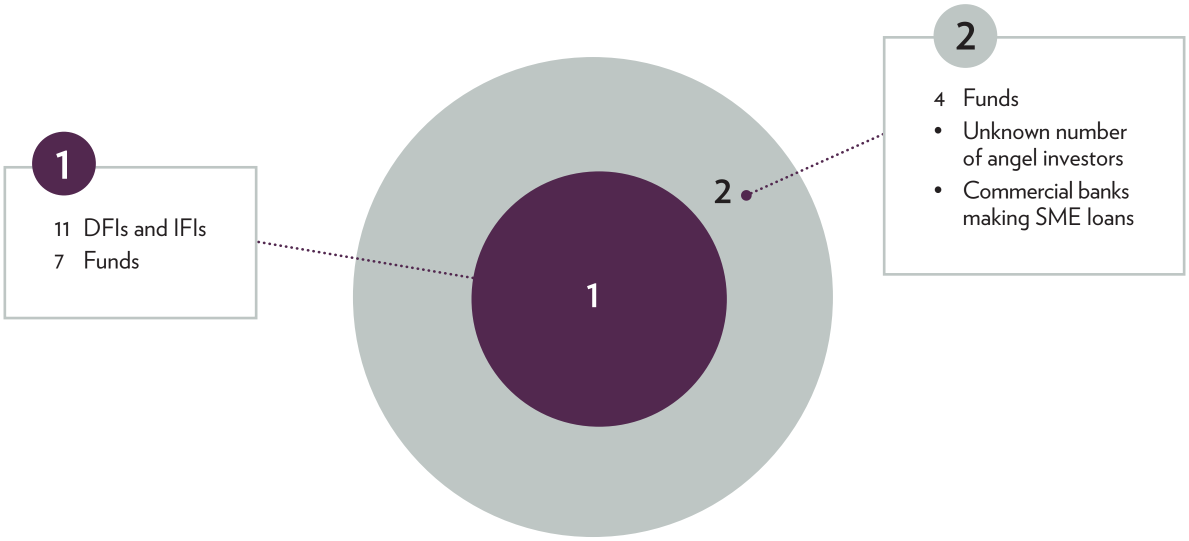
There is a substantial presence of local high net-worth individuals (HNWIs), family offices, and foundations in Pakistan, but not many are actively engaged in impact investing; rather, their intent is either purely philanthropic or commercial. These players mainly provide grant capital to large charities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

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

Funds operating in Pakistan fall across the two rings in our framework.[21] Approximately 36% of capital deployed by funds comes from impact investors (Ring 1) and the remaining 64% from impact-related investors (Ring 2). The key difference between these funds is the articulation of an explicit impact intention. There is a view from many fund managers that impact is achieved by default through their activities—whether this means increased access to capital where there was less before, or impact through investment in sectors like agriculture, which will affect farmer incomes, even without this being intentional ex ante. In terms of measurement, interestingly, even the funds in Ring 2 have plans to introduce a metric-based measurement approach as they are intermediating or planning to intermediate DFI capital, which comes with a requirement to measure and report key impact metrics.

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

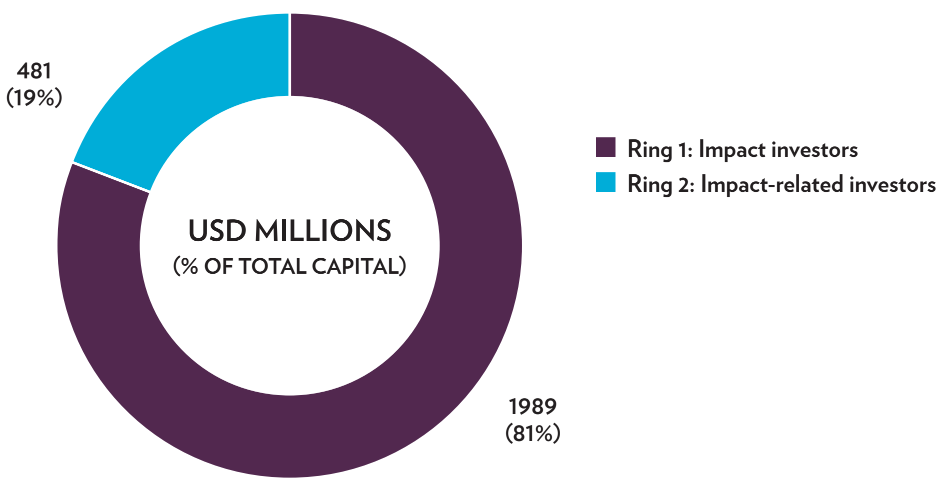
FIGURE 9: DIRECT IMPACT AND IMPACT-RELATED INVESTORS ACTIVE IN PAKISTAN



Sources: Stakeholder interviews, Dalberg analysis

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

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

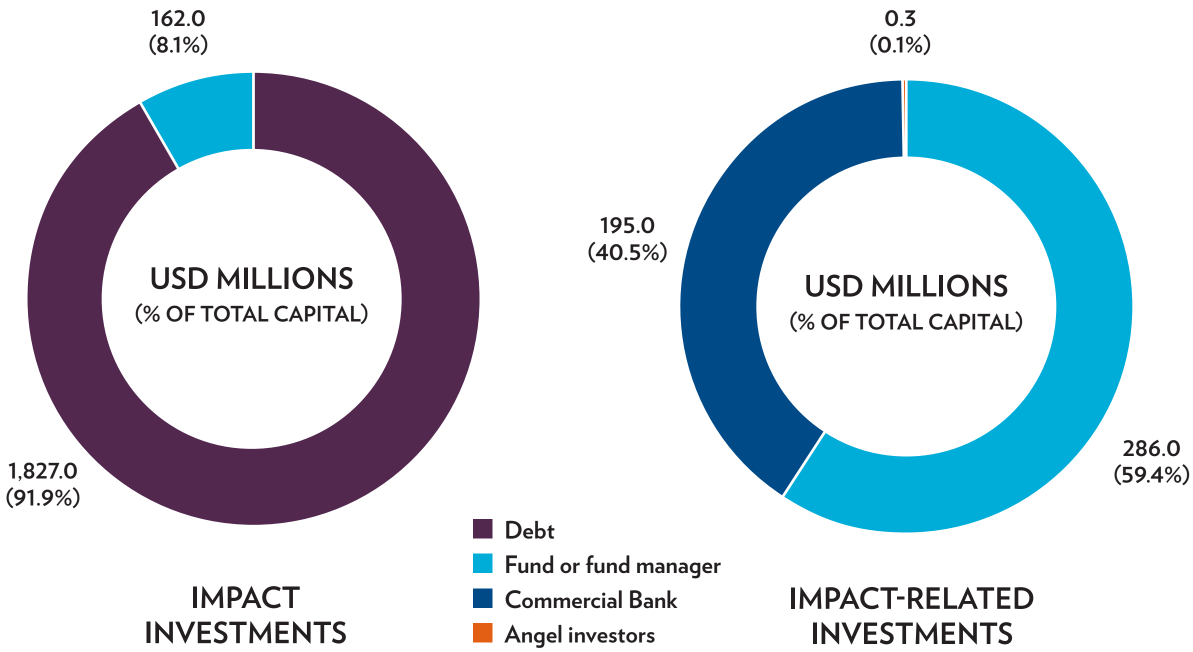


Sources: Stakeholder interviews; Investor websites; Dalberg analysis

INVESTOR MIX

Although we see a range of active investor types in Pakistan, DFIs represent the largest share of capital deployed and drive key trends. 92% of impact capital comes from DFIs, while the remaining 8% comes from fund managers. However, when it comes to impact-related investments, fund managers account for 59.4% of capital deployed and commercial banks (receiving earmarked DFI capital) for 40.5%. Moreover, a portion of the capital deployed by fund managers originates from DFIs as well, increasing their share of the total capital deployed.[22]

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



Sources: Stakeholder interviews; Investor websites; Dalberg analysis

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

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

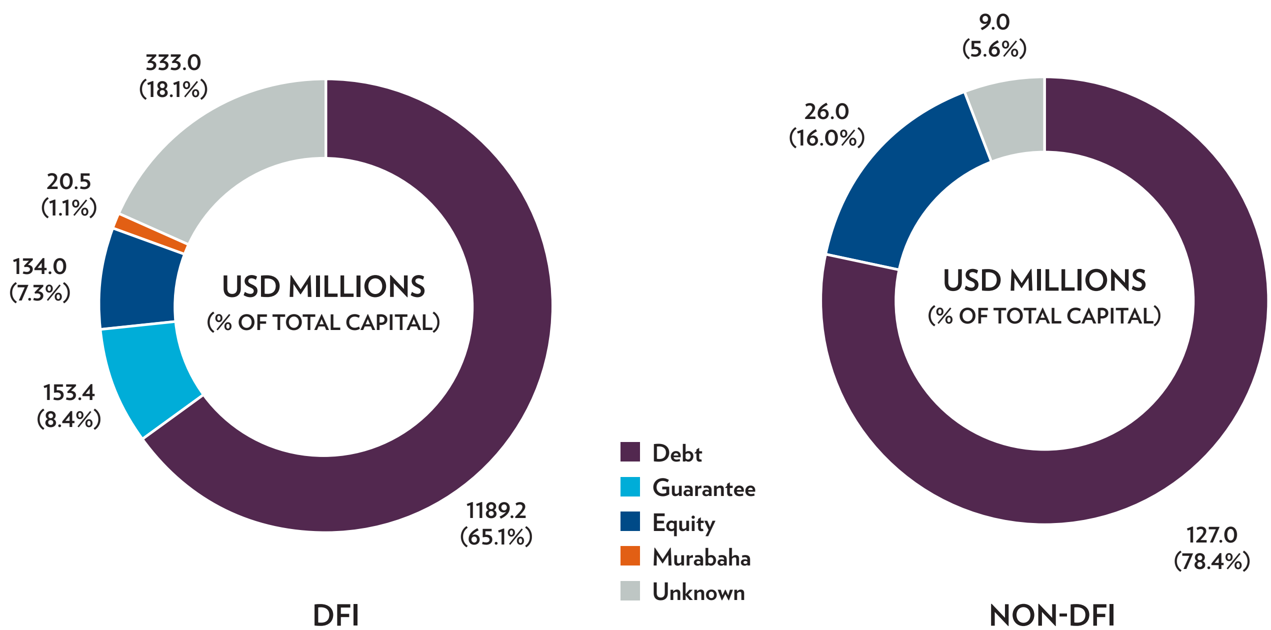
Key trends of impact investing in Pakistan

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

INSTRUMENT

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

FIGURE 12: IMPACT CAPITAL DEPLOYED BY INSTRUMENT



Sources: Stakeholder interviews; Investor websites; Dalberg analysis

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

There is some experimentation with other instruments (guarantees, social impact bonds, and Murabaha) in Pakistan. DFIs offer guarantees to banks to encourage more private sector SME lending, since banks have mainly preferred lending to the public sector where rates are high and defaults low. Murabaha, or zero-interest loans (described in Figure 13), have been used by Middle Eastern investors, who have developed the instrument in line with the principles of Islamic Finance.[23] In a very nascent stage, there are investors exploring the possibility of raising a social impact bond for the education sector in Pakistan as well.

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

Instrument	Rationale
Guarantees	• Bank lending to SME sector is low, since commercial banks view the SME sector as very risky. Hence, to increase the amount of commercial debt SMEs can access, some IFIs/DFIs are providing guarantees to banks • Also provided to commercial banks by institutional investors to increase the funding available to the microfinance sector, as commercial banks tend to be risk averse with respect to this sector • Guarantees provide a multiplier effect in terms of impact, and reduce the amount of risk the investor has to bear
Social impact bonds	• There are a few investors who are looking at using social impact bonds in Pakistan—in the education sector (e.g., a London-based merchant bank created a sample pilot for a DIB for low-cost private schools but has yet to implement/fund this DIB)
Murabaha	• Murabaha is the sale of a good at cost plus an agreed profit mark-up; occurs when an intermediary purchases from the bank at the 'purchase price' and sells to the customer at the 'sale price' • It is different to short-term debt because it is the sale of a tangible asset on a fixed profit margin rather than money advanced • Murabaha is being used by a Middle Eastern investor in Pakistan, where there is a better understanding of Islamic banking principles

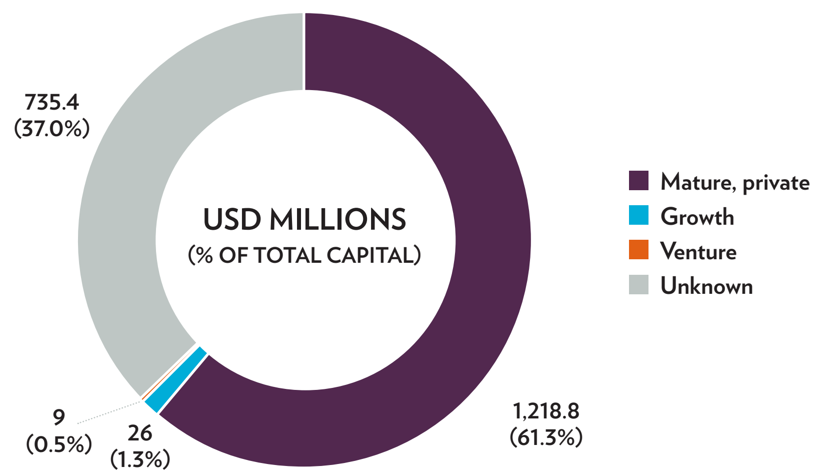
Sources: Stakeholder interviews; Dalberg analysis

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

GROWTH STAGE AND DEAL SIZE

Mature companies have absorbed most of the overall impact capital deployed to date. This trend is again driven by DFIs who are the leading investors in this field and have a preference for larger deal sizes (given the transaction cost of investments), and have invested approximately USD 1.2 billion in mature organizations. Only companies at this stage can absorb these large amounts of capital. Additionally, mature companies have an established operating history, are legally registered, and keep accurate financial records—factors that lower the risk for investors and ease the monitoring process. Meanwhile, investments from fund managers have been exclusively in venture and growth stage organizations (see Figure 14). Unfortunately, for non-DFI investors, information is unknown for a large percentage of investments by stage of business.[24]

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



Sources: Stakeholder interviews; Investor websites; Dalberg analysis

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

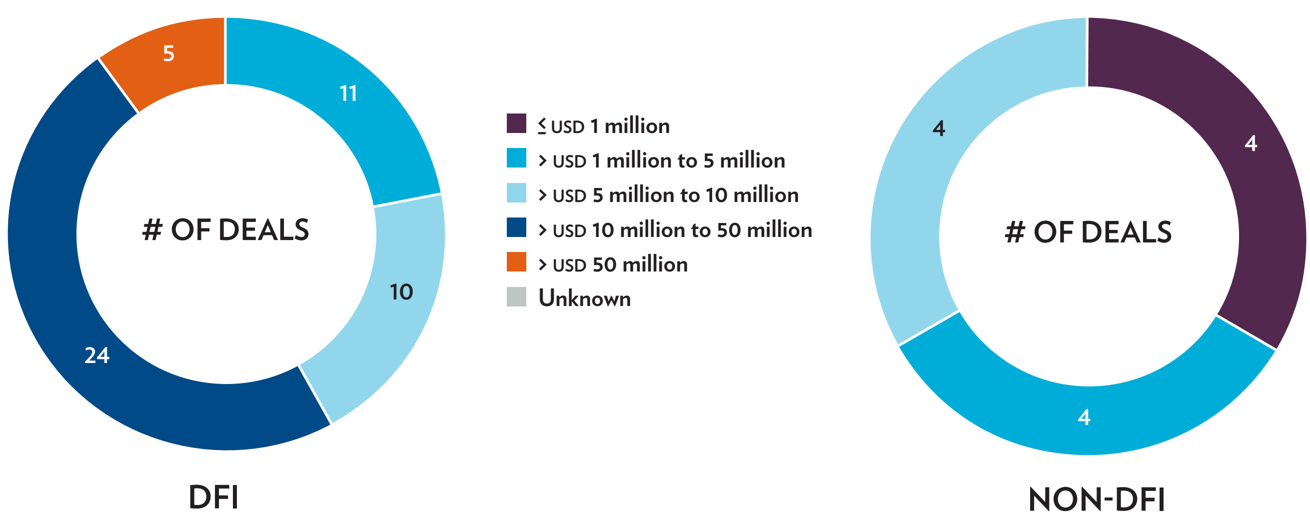
24 *A large percentage of invested funds are unknown with respect to the maturity of the enterprise as the portfolio breakdown of significant investors such as the ADB and the Pakistan Poverty Alleviation Fund is unknown.*

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

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

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

FIGURE 15: NUMBER OF IMPACT INVESTMENT DEALS BY SIZE

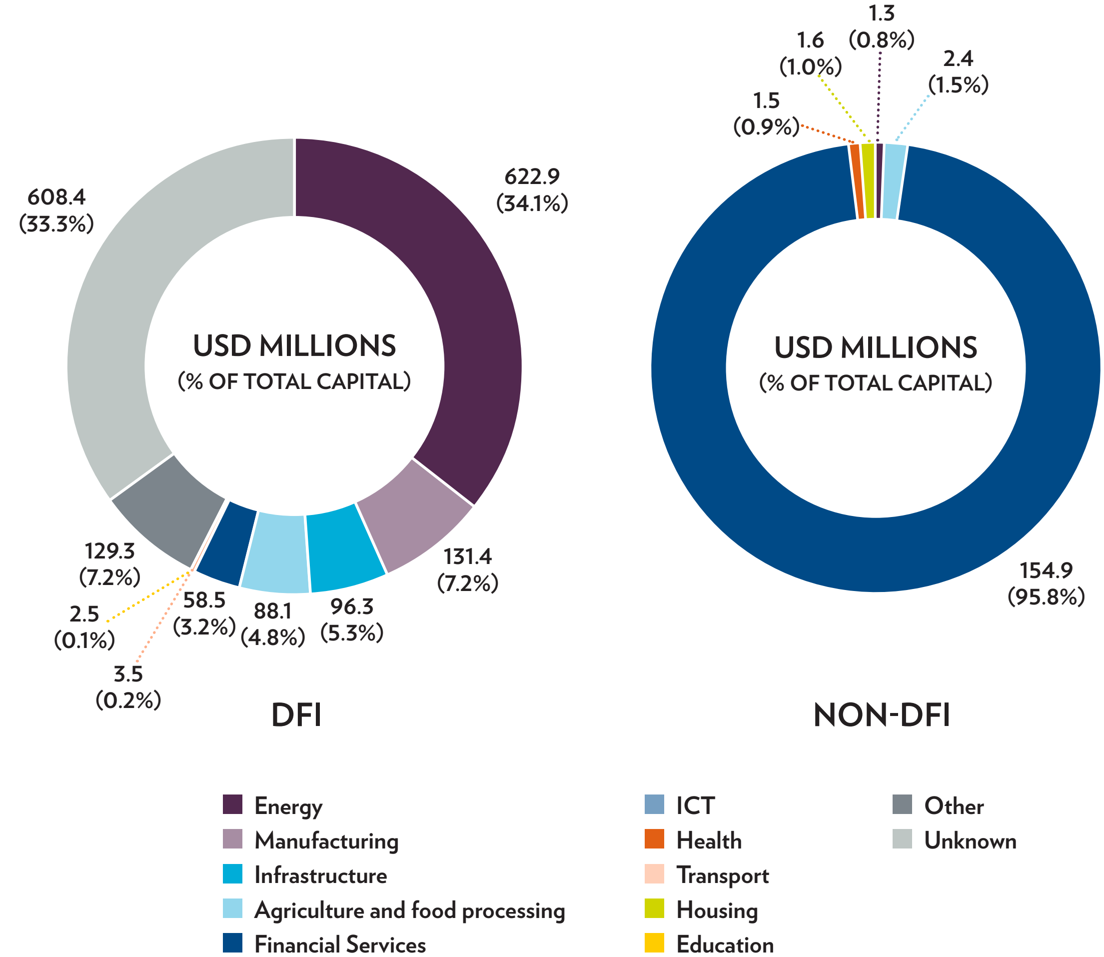


Sources: Stakeholder interviews; Investor websites; Dalberg analysis

SECTOR

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

FIGURE 16: PERCENTAGE OF TOTAL IMPACT CAPITAL DEPLOYED BY SECTOR



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

The microfinance sector has received large amounts of impact capital—predominately from one domestic fund (with source capital from international financial institutions (IFIs)/DFIs). The microfinance sector in Pakistan is particularly interesting for impact investors from both a returns and an impact perspective. Given the large unbanked population and the need for small enterprise loans, the opportunity to invest in microfinance institutions is significant. These institutions are also "known entities" and easier to identify, and the sector is very well regulated, making investments attractive and lowering the risk profile. However, the leading microfinance fund (with a current portfolio of USD 127 million), which has been instrumental to the growth of the industry, can also lend at subsidized rates. This is somewhat of a deterrent for investors as, while attractive to organizations seeking capital, this access to subsidized capital limits opportunities for investors to engage in the sector with market rate expectations. Some impact investors have taken equity stakes in microfinance institutions, but debt is not a viable instrument if not provided at the same subsidized rates.

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

Return expectations and exit possibilities

Equity investors in Pakistan have a wide range of return expectations, but typically expect a return higher than most other asset classes as well as their own cost of capital. Commercial bank interest rates in Pakistan are typically pegged at 15%–20%, and other asset classes provide returns up to about 7%–13% (fixed deposits, government securities, etc.). Capital market gains have been much higher, with the Karachi Stock Exchange offering returns as high as 40% in 2013, much better than the world average.[25]

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

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

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

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

Impact measurement

With respect to impact measurement, the options for investors are to either adopt an existing standardized framework or to create a custom framework. We see DFIs largely using frameworks developed in-house; these frameworks are based on global standardized metrics, such as Impact Reporting and Investment Standards[26] (IRIS) or Environmental, Social, and Governance (ESG) factors, and are used across their portfolios in all countries. ESG metrics measure the environmental, social, and governance performance of enterprises, and metrics for measurement include the number of employees (socio-economic impact) and governance ratings. IRIS is a catalogue of recognized performance metrics, from which investors can choose those that best match their impact strategies and their investees' business models.

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

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

FIGURE 17: INVESTOR IMPACT MEASUREMENT

	METRIC-BASED IMPACT MEASUREMENT	ANECDOTAL IMPACT ASSESSMENT
Rationale for this approach	• If DFI/IFIs acting as LP for fund, metric-based reporting is required • International impact investors have a defined set of metrics that can be applied for their investments in Pakistan without having to develop a new set of metrics	• For more commercially oriented investors, metric-based impact measurement is difficult and is secondary to launching and managing a fund, so anecdotal assessment used as default • Belief that impact is inherent because of the sectors they work in (e.g. agriculture and education) and therefore measurement is not required
Key indicators measured	• Social impact is primarily measured by economic metrics (e.g., number of jobs created) with assumption that economic impact will have social benefits • Some investors are using IRIS metrics or ESG metrics	• Stories of lives touched and entrepreneurs supported by investment
Rationale for indicator selection/ preference	• Selection of indicators is case specific (differs by sector and type of enterprise) • Indirect impact (e.g. quality of life) is difficult to measure, and thus, there exists a preference for economic metrics • Preference for ESG compliance driven by widespread recognition that ESG compliance satisfies basic impact criteria and mitigates risk of non-compliance for investor and investee	• Desire to share qualitative benefits of investment

Sources: Dalberg analysis; Stakeholder interviews

Beyond the impact investing sector

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

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

Challenges facing impact investors in Pakistan

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

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

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

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

Entry into Pakistan	Pipeline development	Screening and due diligence	Structuring investment	Managing investment/ follow up	Exit
Severity of investor challenges, by stage of investment					
Key challenges faced by investors and severity of impact					
Perceptions of insecurity and volatility are strong deterrents for international investors; additional externalities from insecurity in the region, e.g., Afghanistan	Identification of potential investees through networks—few organizations in the ecosystem to help	Few enterprises have the financial and operational management skills that make them investment ready (e.g., poor corporate governance and transparency, and presence of double/ triple books)	Need to educate good enterprises about the benefits of equity and convince them to take on equity	Need for long-term horizon and engagement to get investee up to exit point or able to access follow-on funding	Uncertainty around likelihood/ feasibility of exits via different mechanisms—no track record yet
Business climate supportive; PE regulation still weak—funds prefer offshore domiciliation to start (e.g., need five investors to get FM license; PE license valid only for three years)	Some competition for equity investors from commercially oriented family offices but few debt providers competing (except in microfinance)	Difficult to conduct due diligence—either have to visit in person (difficult for foreign investors), or travel to rural areas (difficult for both local and foreign investors)	Misalignment of preferences between investor and entrepreneur shareholding desired		No local M&A market—need to look abroad for trade sales; secondary sale may be possible as mainstream PE market grows Repatriation of capital difficult in practice—long and bureaucratic approval process

Least severe — Most Severe

Sources: Stakeholder interviews; Dalberg analysis

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

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

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

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

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

As discussed earlier, the lack of a track record in exits makes investors uncertain of the potential exit mechanisms for their equity investments. While there is some expectation that trade sales will be possible domestically, the local mergers and acquisitions market has been fairly slow. Therefore, investors are considering foreign sales either to senior funds or larger enterprises for exits. Moreover, exit horizons in Pakistan are expected to be long—while the traditional five-year horizon is still a target, most investors take a pragmatic view and expect a slightly longer tenure, some as long as 10 years.

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

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

Key Enterprise-Side Gaps Identified By Investors	Severity	Organizations Offering Non-financial Support	Services Offered
Lack of business management skills		• IFC	• Advisory team to provide technical assistance to clients • Web-based SME toolkit
Poor operational/ financial management skills		• USAID • DFID	• Funding allocation for technical assistance to SMEs
Lack of access to information/networks		• i2i • Plan 9 • Seed Incubation Center	• Integration into entrepreneur and funding networks through the incubator/ accelerator model

Least severe
Most severe

Sources: Stakeholder interviews; Investor websites; Dalberg analysis

Looking forward

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

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

NEEDS AND OPPORTUNITIES: THE DEMAND SIDE

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

Given that Pakistan has one of the most vibrant impact enterprise[27] landscapes in the region, we do see a reasonable share of impact capital directed into impact enterprises—primarily into microfinance institutions. To date, according to investors interviewed in Pakistan, the SME sector has been relatively unattractive, although some impact capital has been channeled through commercial banks by DFIs with the intention to increase SME access to capital. However, this is likely to change over the next few years as four new SME-focused funds that are currently raising capital begin to invest.

Overview of impact enterprise ecosystem in Pakistan

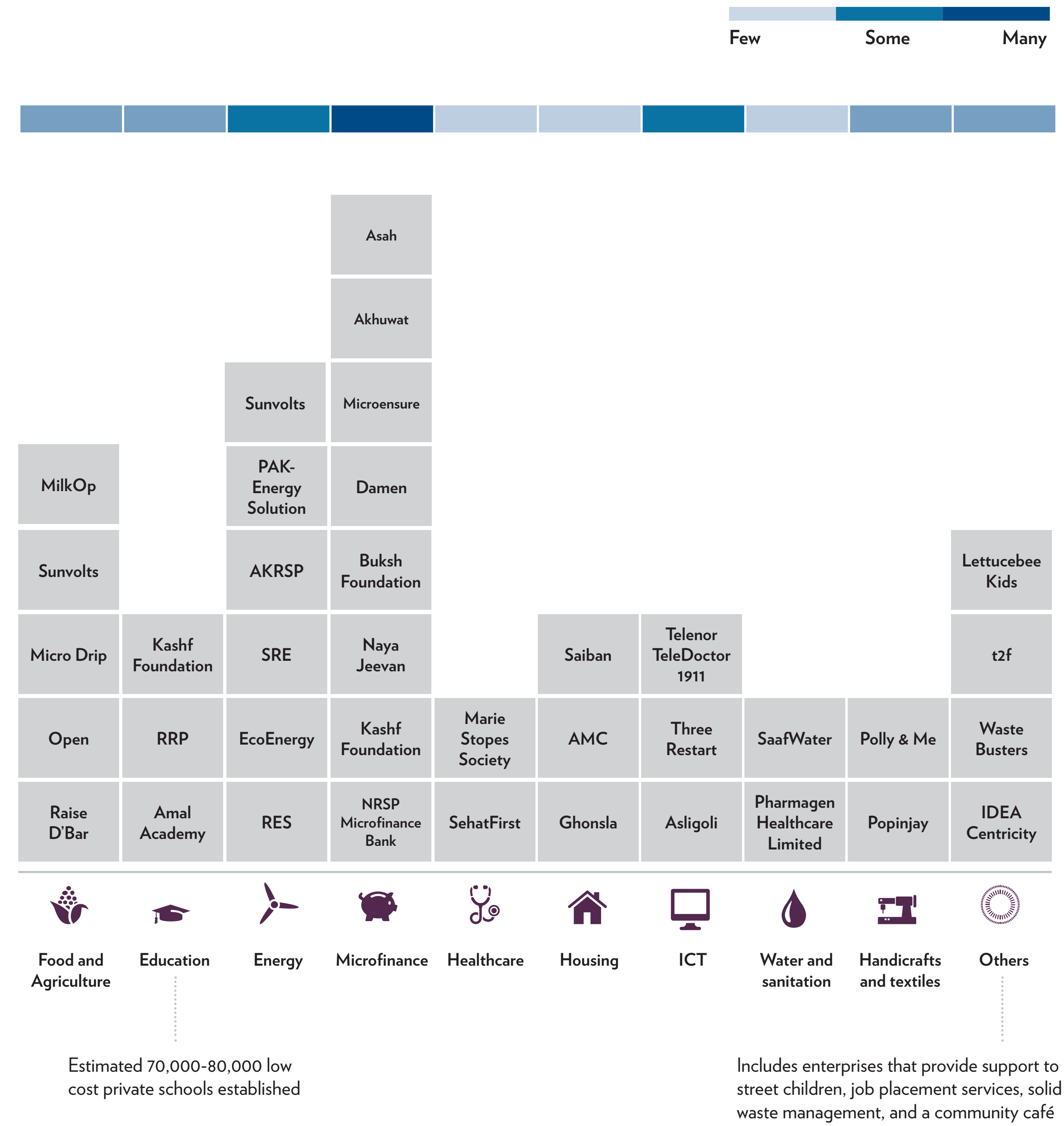
SECTOR TRENDS

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

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

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

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



Sources: Stakeholder interviews; Investor websites; Dalberg analysis

Microfinance is a particularly attractive sector for investors in part due to factors that are standard across all countries—they are better known and easier to identify, and have measurable impact in terms of economic and gender empowerment as well as rural reach—and in part due to the strong and attractive regulatory environment in Pakistan.[28] Pakistan ranks third of 55 countries for favorable regulatory and operating conditions for microfinance. It is one of the few countries in the world that has a separate legal and regulatory framework for microfinance banks and is regarded as one of the most enabling environments for microfinance both regionally and globally.[29] In addition, the State Bank of Pakistan (Pakistan's central bank) mandates that all microfinance banks educate their clients on the terms and conditions of their products, and has institutionalized a procedure for managing and addressing client complaints.[30] Moreover, as of 2013, Pakistan had more than 50,000 fixed microfinance branches, more than 200 mobile branches, and a total gross microfinance loan portfolio of around USD 97 million.[31] In comparison, the number of microfinance branches in Bangladesh in 2009 (latest data year available) was less than 18,000.[32]

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

The education sector is also seen as a sector with enormous potential for impact enterprise models and as a destination for impact capital across the full value chain from pre-school to tertiary education and vocational training. For now, while there are many thousands of low-cost private schools,[33] few are structured as impact enterprises, having been started out of a recognized opportunity to make a quick commercial return in a relatively unregulated industry. Given the lack of regulations, many of these schools are of low quality and not necessarily established with the long-term scale in mind. There is strong investor interest in exploring the opportunities to develop some higher-quality, larger-scale, sustainable and affordable private schools out of this landscape, but these efforts are in their nascent stages and will take time to develop.

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

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

30 Op Cit. Economist Intelligence Unit (2013).

31 Pakistan Microfinance Network, Microwatch*, 2013.*

32 South Asia Micro-entrepreneurs Network (2009).

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

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

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

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

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

The housing sector has been a very challenging sector for entrepreneurs because of issues related to land ownership, a need for a large number of permits and approvals (which are costly and take significant time to obtain), and the large costs involved in projects. Issues related to land ownership include the fact that post-independence Pakistan has retained a feudal system of land tenure in which a small elite class owns a majority of land worked by tenant farmers and laborers. Between 20% and 40% of rural households are reported to be landless or have very little land. Although the government has attempted to address the issue of land and tenure rights, these efforts have largely failed to take effect and change the system.[34] Therefore, this sector is not very attractive despite some interest from investors. In fact, an organization that had received impact investments for a low-cost housing project had to put its project on hold due to administrative and legal constraints.

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

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

While not as dominant a sector as in the other countries in the region (such as Sri Lanka and Nepal), there are a few viable and visible enterprises working in the handicrafts sector, where they seek to increase employment of women[35] and create opportunities for income generation. In addition to some well-known enterprises (e.g., Popinjay), there are several rural microenterprises in this sector, financed initially through microcredit, but not necessarily with an intention to scale. Given the number of microenterprises, this could potentially be a relatively easy sector to promote for impact investors—the so-called "low-hanging fruit" that could be nurtured and supported to grow.

ORGANIZATIONAL TRENDS

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

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

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

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

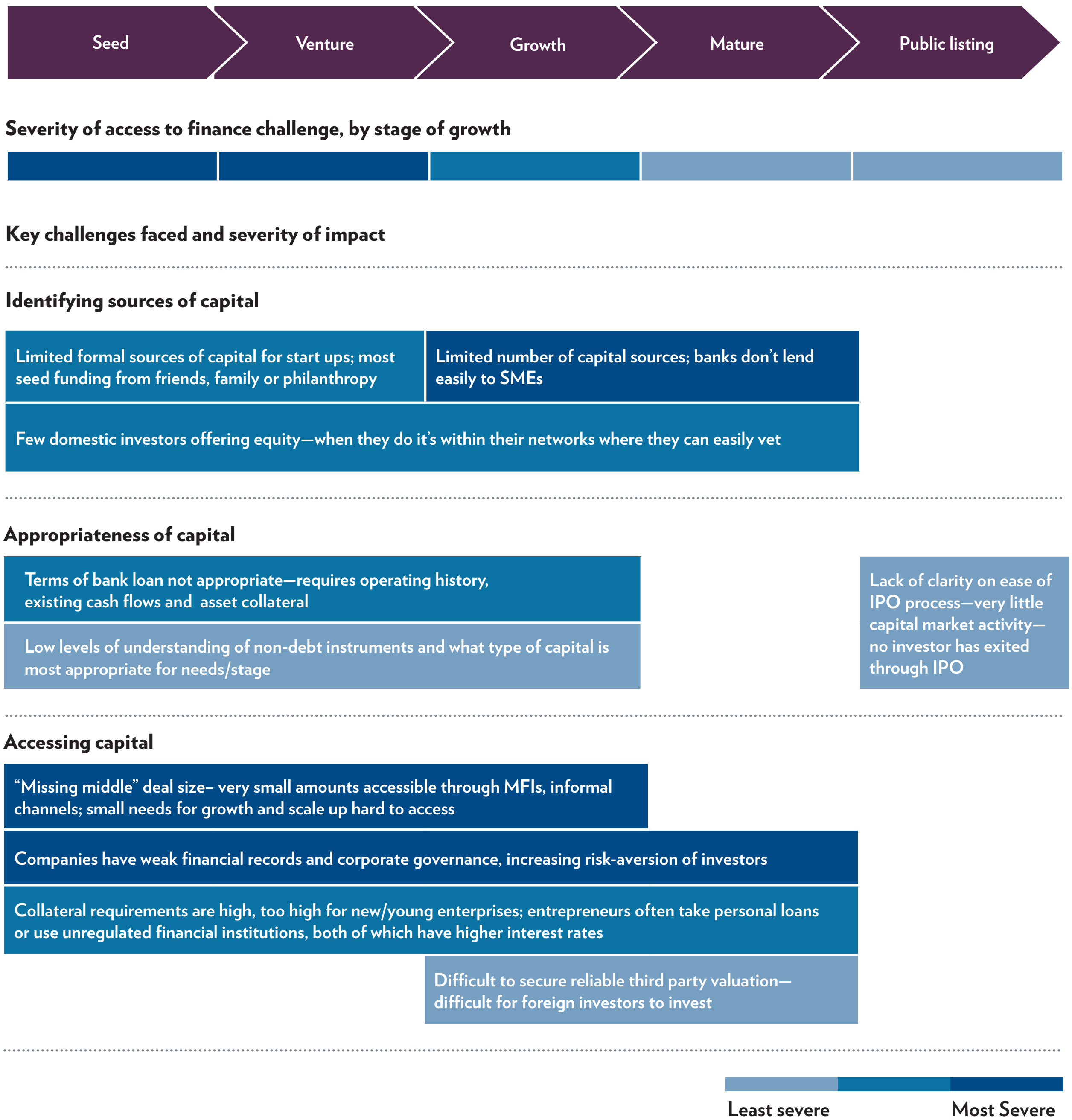
In Pakistan, most of the impact enterprises have been established either by diaspora/Pakistani returnees or by locally well-educated entrepreneurs; very few enterprises have been started by foreigners. The diaspora/returnees are familiar with the concept of impact enterprises, are well-connected both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

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

Access to finance

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

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

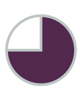


Sources: Stakeholder interviews; Dalberg analysis

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

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

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

Instrument	Preference	Drivers of preference	Key barriers
Private Debt		• Strong banking sector and awareness of how debt operates	• Excessive collateral requirements, short grace periods • High interest rates, up to 20% • Taking debt as start up is risky for both banks and entrepreneurs • Cultural aversion to private debt because Islam discourages charging interest rates
Equity-like debt		• A good way to reduce risks for investors while aligning their interests with those of enterprises	• Instrument is not well understood by both enterprises and investors
Public equity	*Not appropriate instrument for seed or venture stage companies*		
Private Equity		• Less risky for early-stage enterprises • Investors provide mentorship, strategy support, access to networks, etc., in addition to capital • Concept well understood by new entrepreneurs (well educated, diaspora) who may also work with incubators/accelerators	• Few equity investors offering capital to venture stage companies

Least severe
Most severe

Sources: Stakeholder interviews; Dalberg analysis

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

Instrument	Preference	Drivers of preference	Key barriers
Private debt		• Strong awareness of how debt operates • Established businesses with collateral, profits, and strong networks find it easy to access commercial debt • Less involved diligence than for equity • Debt more appropriate for working capital	• High collateral requirements and interest rates • Banks may still be unwilling to lend to some sectors like microfinance, which is deemed risky because they can make same returns on government lending
Equity-like debt		• Creates flexibility—can pay back equity as debt to exit for equity shareholders, or vice versa	• Not a common instrument offered by investors • Little understanding among enterprises
Public equity		• Creates exit option for promoter	• Family-owned businesses averse to increased transparency and external shareholding
Private equity		• Growing number of equity investors • Increasing recognition of value of equity investments—investors bring experience, networks, and additional support other than capital • Long-term relationship and financial horizon	• Some enterprises reluctant to give up equity in their company—need education and convincng by investors (especially since mature companies tend to be family owned businesses) • Few private equity investors

Least severe

Most severe

Sources: Stakeholder interviews; Dalberg analysis

Constraints to enterprise growth

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

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

- **Corporate governance and financial management**: Governance structures are usually weak and not designed for enterprise growth. Financial management skills are similarly often weak, including low capacity for financial record keeping and planning, which limits the development and growth of SMEs and start-ups in particular.

- **Marketing and market access capabilities**: This is generally a weak area for entrepreneurs in consumer-facing industries as the customer acquisition expertise of these entrepreneurs is low; this constrains growth in an environment where consumers are very distrusting until the product or service has been proved to be significantly credible. In particular, entrepreneurs have limited expertise in assessing markets and developing sales plans for growth.

ENABLING IMPACT INVESTING: THE ECOSYSTEM

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

Given that Pakistan has largely maintained an open investment regime since 1997, the regulatory environment is generally perceived as favorable to foreign investors. However, the implementation of these regulations and the everyday experience of navigating them are reported as greater concerns for domestic investors. The Government of Pakistan (GoP) offers incentives to attract new foreign capital inflows, such as tax exemptions, reduced tariffs, and investor facilitation in designated special economic zones.[36] To continue attracting investment, the GoP also announced the 2013 Investment Policy, which further liberalized investment policies to almost all sectors. With respect to PE laws for foreign investors, the minimum initial capital investment required in all sectors—including services—was eliminated in the 2013 Investment Policy. There is currently no minimum requirement for the amount of foreign equity investment needed in any sector; moreover, there is no upper limit on the share of foreign equity allowed.

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

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

and process of acquiring construction permits.[37] Moreover, domestic investors perceive and encounter corruption as a more significant issue than foreign investors, particularly with respect to government procurements and establishing a business. While Pakistani law provides criminal penalties for corruption, implementation of the law is incomplete, and thus, in practice, it forms a significant barrier to smooth and efficient business operations.[38]

FIGURE 24: INVESTMENT CLIMATE OVERVIEW BY SEVERITY RATING

	Key components	Key ecosystem constraints in Pakistan	Severity (foreign investors)	Severity (domestic investors)
Investment climate	Political stability and governance	• Pakistan has been embroiled in high political insecurity, and there is worry that governments are taking a short-term approach to policy making • Security and terrorism threats remain high—while only certain areas are still in active conflict, violence and instability is a worry in all areas • Human rights violations are also a concern to foreign investors due to reputational risk		
	Infrastructure	• Acute power shortages in most parts of Pakistan; high proportion of the country remains under- or un-electrified • High government and foreign direct investments in infrastructure—extensive rail and road networks, established networks of dry ports, and seaports		
	Macroeconomic governance	• Between 2008 and 2013, FDI into Pakistan declined by approximately 70% • Growth rates lowest in the South Asia region • High inflation rates, high interest rates, and high tax rates • Several macroeconomic reforms have been implemented in the recent years—especially as a result of entering into a three-year Extended Fund Facility arrangement with IMF		
	Regulatory environment	• Liberal regulatory environment; open to foreign investment—foreign equity up to 100% allowed, no government permission required, attractive incentive packages • Strong governance of banking and financial sector; well-established banking system. • Board of Investments attached to PM's office since 2009 to ensure ease of process • Regulation "criminalizes good actors and rewards bad actors," encouraging enterprises to take short-cuts or illegal measures • Locals find the process of starting a business, launching a fund, or launching a new financial mechanism inefficient, requiring several levels of bureaucracy		

Least severe
Most severe

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

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37 *World Bank 2014 "Doing Business" rankings; Pakistan and US Department of State (2014).*

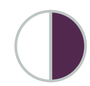
38 *Pakistan ranked 127th of 177 countries in the Transparency International Corruption Perceptions Index (2013).*

With respect to macroeconomic governance, Pakistan has a liberal foreign exchange regime and its policies support the free flow of resources for domestic and foreign investors,[39] but its taxation and inflation rates remain a significant barrier for both foreign and domestic investors. Investors are faced with a complex assortment of both federal and provincial taxes and controls, which are overseen with much administrative discretion, resulting in inefficiency and corruption. The GoP and the World Bank launched a multi-year tax reform program in 2004 that was extended until 2011; while there are still major issues with the taxation system, this initiative helped the GoP reorganize its Federal Board of Revenue in establishing a large tax unit. However, political tensions prevented the GoP from presenting an IMF-mandated tax measure to the Parliament in 2010, and Pakistan's tax-to-GDP ratio still remains among the lowest worldwide. In addition, the other macroeconomic barriers faced by investors include high inflation and a relatively volatile currency that can depreciate dramatically.

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

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

FIGURE 25: CONSTRAINTS TO INVESTOR AND ENTERPRISE SUPPORT IN PAKISTAN

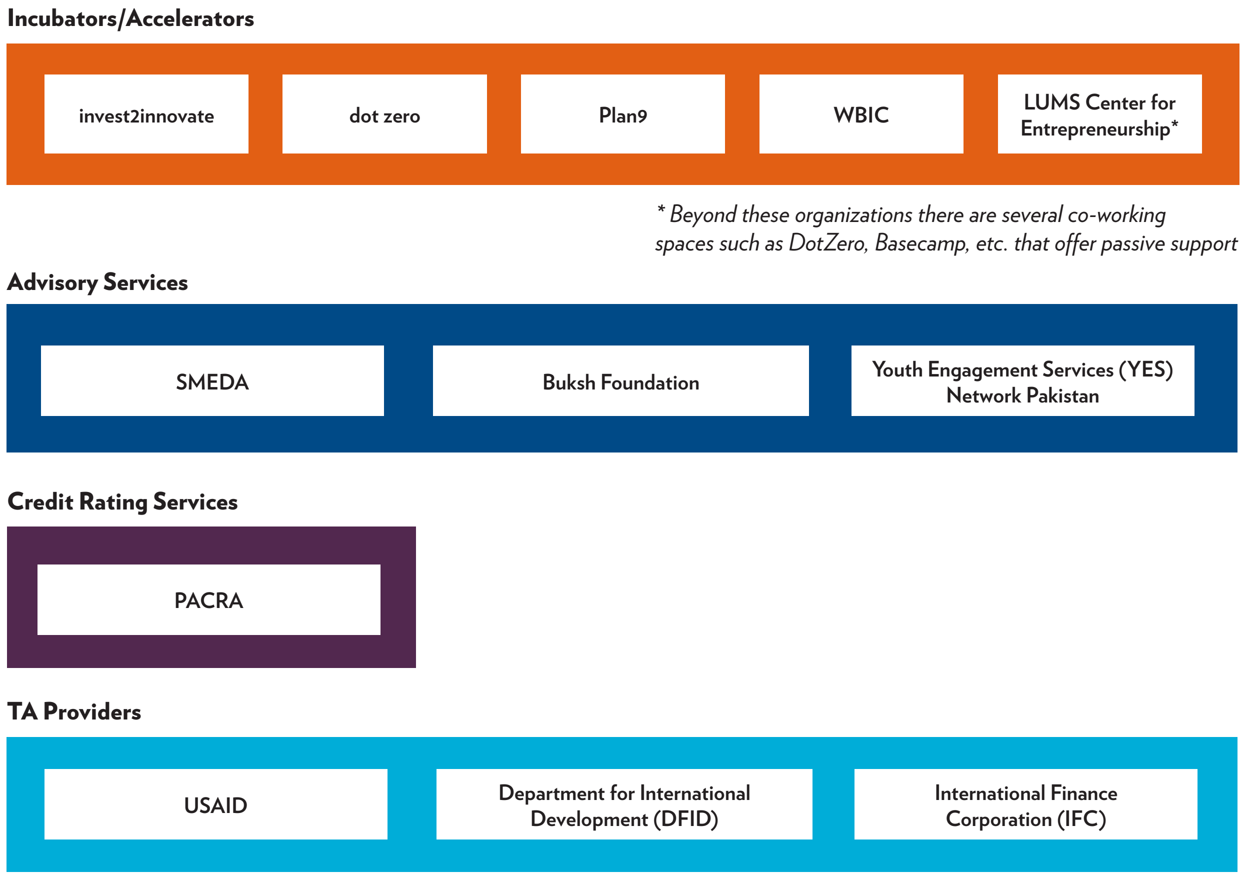
	Key components	Key ecosystem constraints in Pakistan	Severity of constraint
Investor and Enterprise support	Investor support	• Presence of general service providers (e.g., for legal, accounting, and registration support); however, few specialized investment advisory firms are present that can help with specialized functions such as deal sourcing and due diligence • Key areas of need include » Firms that can do due diligence on the ground, given security concerns that prevent investors from traveling to Pakistan » Need for firms who can help investors with pipeline development given closeness of social and business networks and importance of relationships to navigate these » More asset management support providers or BDS providers that can work with international equity investors who are wary of setting up a local presence due to security risks	
	Enterprise support	• Other than access to finance, key challenges for enterprises include access to markets, difficulty in hiring and retaining qualified staff, and security concerns • While there is a growing presence of enterprise support and development organizations, including incubators, accelerators, and BDS providers, the overall landscape is still developing • A few new aggregators are emerging who help enterprises access support • Key areas of need include: » Vocational/skills training institute to increase pool of qualified staff » Increase in the number of BDS providers » More incubators and accelerators, especially having a non-tech focus » Efforts to change mindset about working at SMEs	

Least severe
Most severe

Sources: Stakeholder interviews; Dalberg analysis

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

FIGURE 26: SAMPLE ORGANIZATIONS IN PAKISTAN'S SUPPORT ECOSYSTEM



Sources: Stakeholder interviews; Investor websites; Dalberg analysis

AREAS FOR FURTHER RESEARCH

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

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

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

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

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

ANNEXES

Annex 1—Interview participants

FUND OR FUND MANAGERS

- Ahmad Jalal, *Abraaj Group*
- Shuaib Siddiqui and Farrukh H. Khan, *Acumen Fund*

DFIS/IFIS

- Faeyza Khan, *IFC*
- Fay Chetnakarnkul, *Norfund*
- Yasir Ashfaq, *Pakistan Poverty Alleviation Fund*
- Maryam Riaz, *USAID*

INSTITUTIONAL INVESTORS

- Rashid Bajwa, *National Rural Support Program*
- Atyab Tahir, *Tameer Bank*

ECOSYSTEM PLAYERS

- Fiza Farhan, *Buksh Foundation*
- Jeremy Higgs, *Ecoenergy Finance*
- Roshaneh Zafar, *Kashf Foundation*
- Asher Hasan, *Neya Jeevan*

Annex 2—Survey respondents

FUND OR FUND MANAGERS

- Shuaib Siddiqui and Farrukh H. Khan, *Acumen Fund*