

Leveraging Equity Investments to Build Inclusive Financial Markets

Equity as a funding instrument is particularly important for the responsible development of financial markets. Through purchasing shares in financial services providers (FSPs) and other types of institutions, development finance institutions (DFIs) and social investors have three distinct opportunities to shape market players and in turn influence how markets develop by potentially driving competition, promoting innovation, improving market efficiencies, creating demonstration to crowd-in others and ultimately better serve customers (Figure 1).

Compared to lenders,¹ equity investors can have a substantially wider choice of investees at the starting point, or **entry**. Because lenders can earn only the margin between their funding cost and the interest and fees determined upfront with the borrower, their investment portfolio is limited to companies with more regular cash flows. In contrast, equity can be placed in start-ups, firms with relatively low revenues now but with strong upside potential later. The higher returns potentially available to equity investors enable them to take more risks and a loss on one investment can, at least theoretically, be offset by the gain on another so long as there is a sizeable investment portfolio.

Equity investors also contribute to these returns by being actively involved in the development and **governance** of the investee. In contrast, lenders usually can influence a borrower through loan covenants that prevent certain activities or through providing loans that develop others, such as small business lending. Lender influence, however, is defined in the loan conditions and does not change during the life of the loan unless the borrower fails to perform. Through governance, equity investors

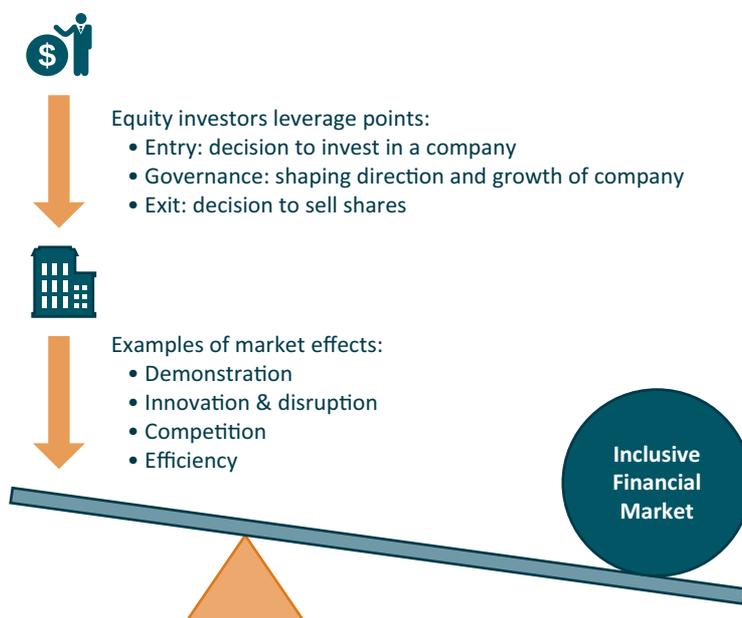
have the opportunity to build the capacity of the investee and contribute to creating the next generation of leaders in the market.

The investor's **exit** decision results in a change of ownership that can potentially change a business's strategy and how markets develop. A new owner, for example, might have different growth and profitability goals for an FSP that could be hard to reconcile with the nature of serving the bottom of the pyramid segment. Similarly, return expectations can signal what potential buyers should expect and the type of buyers it could attract. Loan repayment, by contrast, does not affect the borrower's ownership; at most it releases any assets that were used as collateral. Timing considerations are also very different for debt and equity. Lenders require fixed maturity dates that are enforced by debt contracts, while equity investors have at least some flexibility, depending on their funding sources and internal policies, and have to be patient and to try to sell their shares when they have achieved their objectives.

If equity investors want to maximize their impact, they should focus more on how they can engage with their investees to act in ways that develop the market, and use their three leverage points—entry, governance, and exit—more effectively. The shift to this broader market lens does not mean that equity investors need to compromise on their investment goals; rather, they can pursue their interests in ways that also benefit the market as a whole. For example, they could invest in a leading FSP that intends to serve a client segment that is perceived by others as being too risky. By developing this FSP's management team and helping it succeed in going down market, the

¹ The analysis compares equity with debt for illustration purposes to emphasize the uniqueness of equity's role. This comparison is not intended to diminish the importance of debt in market development or to ignore the fact that there are a number of hybrid products with a combination of debt and equity characteristics. The analysis also does not address grant funding, although it is also extremely important to institutional development, because the ability to make grants is not unique to equity investors.

Figure 1. Equity Investors' Leverage Points



investor has the opportunity to help crowd-in other market players by demonstrating that this particular segment can be served profitably and at scale.

Considering the broader market requires investors to have a deep understanding of the causes of financial exclusion and market barriers that keep poor people financially excluded. This knowledge should be an integral part of their approach to selecting investees so that they can determine how they will add value through their investments—how they intend to exercise their leverage points and become more responsive to these barriers (Roskamp 2014).

In financial inclusion, most DFIs and microfinance investment vehicles (MIVs)² use a **thematic approach** to equity investing. With this approach, an investor chooses to operate within a specific industry and/or geography. Potential investments are examined within the selected sector,

and decisions are based on a combination of the team, competitive environment, and geographical scope. For example, Caspian Impact Investment Advisers, a private equity fund manager focused on socially responsible businesses in India, sought ways to apply the expertise gained from its experience in microfinance to other challenges facing low-income communities. It capitalized on the knowledge and work that FSG—a nonprofit organization working on inclusive markets and formerly known as Monitor Inclusive Markets (MIM)—initiated in 2006 to develop a market-building approach to the lack of affordable housing for low-income households in India³ as well as its on-the-ground experience to identify a new market development opportunity that investors had not yet considered. By creating a financial inclusion fund, Caspian had the possibility to invest in a new theme and “test” the investor and investee market, which later developed into a popular market segment for other fund managers. (For more information see “Looking Ahead”).

2 According to CGAP's MIVs Disclosure Guidelines, MIVs are independent investment entities that specialize in microfinance, with more than 50 percent of their noncash assets invested in microfinance. They are either self-managed or managed by an investment management firm and are open to multiple investors. MIVs may issue shares, notes, or other financial instruments.

3 MIM, an economic development consulting firm, initiated a donor-funded project in 2006 to develop a market-driven response to the lack of affordable housing for low-income households in India. Its analysis showed that construction of apartments for this market would be a profitable business.

A relatively new approach to equity investing in financial inclusion is **thesis investing**. In this approach, an investor elaborates an intellectual foundation about a specific theme. The thesis will include a concrete set of problems or opportunities, a particular view of how the world will look in the future, and a specific set of factors that need to be addressed to get there. The investor will then attempt to structure investment activities around the thesis by either identifying existing companies that fit into the investment thesis or helping create new ones that can take advantage of an identified opportunity. Based on a system-level understanding of the most significant impediments for financial inclusion, Omidyar Network (ON), for example, developed three theses around possible solutions: (i) reduce the cost of reaching underserved populations in emerging markets by promoting the digitization of the retail front-end of financial services delivery; (ii) disrupt the high cost of risk assessment for billions of consumers with no or little credit history using sophisticated analytics of alternative digital footprints; and (iii) deliver a complete suite of financial products and services to unbanked and financially underserved consumers by scaling technology-driven innovations. ON has subsequently made a number of equity investments, both directly and through funds, in start-ups that are building mobile-based delivery infrastructure in several regions.⁴

As impact investing continues to gain traction, DFIs and social investors have a unique opportunity to use their equity funding instrument to contribute further to the development of financially inclusive markets and achieve sustainable impact. In this context, this Focus Note seeks to explore how it can be done by articulating (i) the three leverage points of equity investment; (ii) the challenges for investors to exercise their leverages effectively and possible solutions; and (iii) areas that require further consideration.

Equity Investment and Its Three Leverage Points

This section analyzes the three points at which equity investors have particular leverage—(i) entry, (ii) governance, and (iii) exit—and how they can use this leverage to contribute to market development as well as the success of their specific investee.

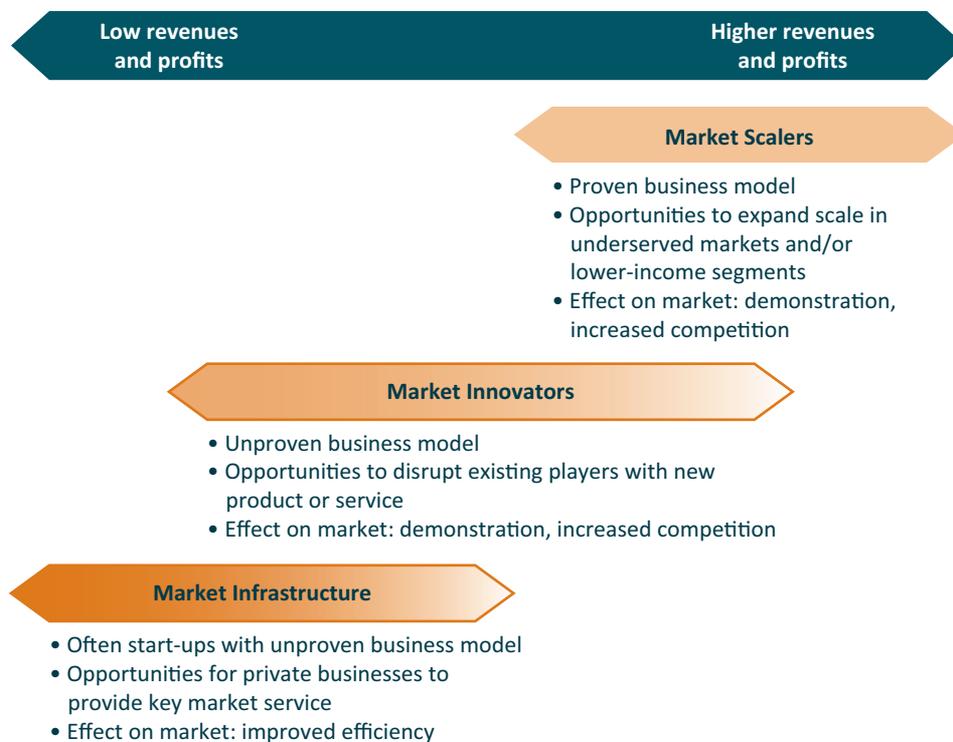
Entry: A Wide Range of Investment Opportunities

The broader range of potential investees presents an opportunity for equity investors to influence market development. There are three broad types of firms in which equity investors can invest, each playing a different role in how markets evolve (see Figure 2).

- 1. Market innovators.** Sometimes individuals and firms create new products or services in ways that the market does not expect. While their business model is not fully developed and tested, innovators can potentially disrupt an existing market or create a new one. Equity investors play a particularly catalytic role in providing capital to innovative businesses, which are typically too risky or do not yet have sufficient regular cash flow to attract debt funding. Furthermore, often new, sparsely staffed businesses require significant support and expertise that an equity investor can bring to develop the innovations into sustainable businesses. Prominent examples of innovators in the financial sector are companies involved in the delivery of digital financial services (DFS) by leveraging information and communication technology and distribution networks.
- 2. Market scalars.** Businesses with a proven business model are well-positioned for significant expansion in underserved markets and/or lower-income segments. Although the model itself is no longer

⁴ ON seeks to create impact at the sector level, beyond the level of individual institutions, by making both direct for-profit investments and nonprofit grants. For each sector in which it invests, ON develops a system-level understanding of the most significant impediments and a set of investment theses around possible solutions. ON's sector-level understanding in financial inclusion led to applying a three-pronged approach to (i) make catalytic investments in early-stage, technology-driven companies that can demonstrate the success of innovative, market-based solutions; (ii) advance sector learnings and knowledge dissemination with a view to inform both policy and product and service design; and (iii) support relevant regulation and policy changes that promote more inclusive financial systems. Although many investors do not have the resources to make grants and support market development as extensively as ON, its approach provides a concrete example of how to apply a market development perspective making decisions about individual investments.

Figure 2. Spectrum of Investment Opportunities



Source: Adapted from Bannick and Goodman (2012).

considered risky and of uncertain profitability,⁵ expansion entails risks of its own because it tests management and operational capacity as well as market demand in different segments. Investments in financial market scalers can contribute to demonstration effects and increased competition in markets. Microfinance institutions (MFIs) are an example of investees that have often proven themselves as market scalers in the financial sector.

3. Market infrastructure businesses. One of the key elements to building inclusive markets is to have an infrastructure in place that supports and improves their overall efficiency. In the financial sector, it typically includes information platforms, credit bureaus, rating agencies, collateral registries, and electronic payment platforms. Policy and regulation usually influence whether market infrastructure is provided by the public or private sector, and it is often a role played by public sector actors and NGOs. But there are also opportunities for private businesses to engage

in providing these services. Investment in such businesses could contribute to improving the market's overall efficiency. Often, these companies are start-ups that can benefit from capital infusion as well as expertise that equity investors can bring to launch the product to market. But not all investments in market infrastructure businesses automatically optimize market development. For example, a private credit bureau open only to banks would not be as good for the market as one that allows participation by all types of lenders. By providing strategic guidance and expertise, equity investors can also work with the market infrastructure business to ensure that it has a positive effect on the market.

Governance: An Influencing Voice in the Boardroom

Ownership rights are the leverage point that equity investors can use to add value throughout the life

⁵ Market scalers are typically companies that developed and rolled out a product, validated its profitability, and had adequate organizational and management systems to bring the business to scale. For investors, these businesses present less risk and potentially attractive returns.

of the investment. Equity investors directly impact corporate governance by maintaining shareholder rights, including the possible right to nominate one or more board members. The board of directors in turn makes decisions about the investee's strategy and selects and oversees the management team that implements that strategy. Governance and support for business development more generally from equity investors is particularly important for market innovators and market infrastructure businesses to help develop/prove sustainable business models.⁶

Careful selection, participation, and strategic guidance of board members in the business can influence market development. Companies in which the board of directors effectively supervises a capable management team have a higher likelihood of achieving their objectives. These objectives, such as developing an innovative business model or scaling a proven business model, can have an impact on the market by creating a demonstration effect, crowding in others including new investors, and/or influencing the competitive environment.

Caspian Impact Investment Advisers did more than identify investees, for example. Through active governance, it shared its microfinance and mortgage expertise to help housing finance companies develop their business models on a sustainable basis, and several of Caspian's investees were able to attract second-round financing from new investors. Accion's Venture Lab—a global investment vehicle that provides seed capital to financial inclusion start-ups—supports the day-to-day operations of its investees through active governance to maximize chances of success. It is also uniquely positioned to connect its investees with Accion's in-house technical experts and the broader financial inclusion community.

Effects on the market, such as demonstrations that pave the way for others, are more likely to take

place, however, if the successes (and failures) are well documented with relevant information and widely shared with or otherwise observable by the market (see Box 1). A company's success can also contribute to market transparency, to the extent that the management and board permit information about the company, its products, and its financial performance to be readily available.

Effective corporate governance can contribute to other development objectives, including explicit commitments to responsible business practices, such as adopting the Client Protection Principles⁷ or the Universal Standards for Social Performance Management,⁸ which are prominent in the microfinance sector.

Investees may also contribute to market development by other means than running a successful business, for example, by helping to found or lead an industry association, being active in data platforms, or contributing to research and surveys that generate useful market information. The board of directors and shareholders can encourage these leadership roles rather than seeing them as diverting management time and resources from the core business.

Exit: Key Signals to the Market

An investor's decision to sell its shares and the resulting change in ownership can have a profound impact on the investee's future; the way it exits can also send important signals to other market players. The ideal exit for a DFI or social investor is one that validates the objectives of the investment: the investor will have achieved its financial and other objectives, and the new buyer will be committed to further develop the investee's mission. This positive outcome provides encouragement for investors and business owners that are already in this market or are considering entering it.

⁶ ON has observed that the human capital costs of working with early-stage businesses can often exceed the financial costs (Bannick and Goodman 2012).

⁷ The Client Protection Principles are the minimum standards that clients should expect to receive when doing business with an MFI. For more information, see <http://www.smartcampaign.org/about/smart-microfinance-and-the-client-protection-principles>.

⁸ The Universal Standards for Social Performance Management, adopted by the Social Performance Task Force, provide a set of management standards to help guide these actions for all MFIs pursuing a double bottom line.

Box 1. What can investors do to create demonstration?

Demonstration is an important part of building inclusive markets and creating impact. It is about testing and proving the validity of a new business model, product, or any other type of innovation to stimulate other market actors to adopt a new type of behavior. Firms can indeed have ripple effects on the market such as (i) inspiring copycats, (ii) generating a competitive response from existing businesses, and (iii) focusing attention on previously unidentified market shortcomings (Kubzansky and Breloff 2014). So, by investing in and working closely with different kinds of firms, equity investors have the opportunity to create demonstration.

However, showing that something works in practice or correcting an inaccurate market perception doesn't always happen because of an investment. Often, when results are not well known or the reasons for success are not clearly understood, other actors are less likely to learn, adopt, or even enhance their existing practices.

Information plays an essential role. Impact investors need to have a deliberate plan for how knowledge about the demonstration will be transferred to others. This starts by defining upfront what is being demonstrated. It could include proving the viability of a specific product, a specific process, an organizational structure, or a business philosophy, such as responsible relationships with clients.

Impact investors also need to make sure that relevant information is extracted. Although businesses typically produce a variety of marketing and product information, this information is not necessarily designed to provide convincing evidence of the viability of a new product or approach. Even financial

information that shows that a company is profitable does not typically include sufficient detail for an outsider to assess and replicate the results.

Sharing relevant facts to demonstrate that results are achievable is paramount. The type of information will vary from case to case, but it will often be centered on overturning assumptions. For example, if market actors generally perceive a particular client segment as too risky for credit, sharing information on the innovator's loan portfolio quality could correct the misperception. If a new business philosophy is introduced as a way to better serve clients, such as customer centricity, client survey results and repeat transaction data might be helpful to make the case for such practices and the returns they can generate if adopted by other market actors. So, the type of information to share is less about the methodology for achieving the results, which is usually proprietary information, but more about showing evidence that they are achievable.

Active dissemination is another key ingredient to demonstration. For example, Accion's Venture Lab puts an emphasis on proactively sharing its investees' stories, successes, and even failures. Staff do not simply ensure that information is made available; they actively monitor media hits and industry "buzz" to assess how the information is being disseminated (Breloff and Khosla 2014).

Finally, impact investors should determine whether the demonstration effect has been achieved. Has the proof of concept been established that the company is able to attract new investors? Are other businesses copying the innovation? If not, why not?

Exiting investors need to carefully consider four key strategic decisions (Rozas 2014):

1. **When to sell:** The desired timing and avenue of exit should be part of an investor's decision to invest. These plans and preferences should be discussed with the other equity investors and the MFI's management.
2. **Who to sell to:** Investors need to weigh two key issues when considering potential buyers. First, they need to ascertain to what extent the buyer is a like-minded investor that shares a commitment to a business' stated mission and can be trusted to "stay the course" over time; this point is particularly important for FSPs with a strong social commitment. Second, they need to consider how the potential buyer can add value

to the company in terms of strategic direction, specialized expertise, and growth capital.

3. **With what conditions and mechanisms:** Putting provisions in shareholder agreements might help codify and reinforce the business's mission and social commitment. However, it can also send an important signal to potential buyers who may be put off by such provisions. The legal enforceability of such shareholder provisions varies widely from one jurisdiction to another, and this approach would work only if the majority of investors support these commitments.
4. **At what price:** Exits that are unprofitable or are seen to have failed in other ways create warning signals for other investors. Extraordinarily profitable exits risk creating unrealistic expectations as well as undesirable headlines.⁹

⁹ Exits also have a very practical impact on existing investors, who typically have to value their investments on a regular basis for reporting to their funders. Recent exit prices play an important role in the valuation process.

Challenges for Impact Investors to Exercise Their Leverage Effectively

For equity investors to succeed in leveraging their investments to develop the broader market, they will need to shift the way they work in ways that might be challenging for some. This section explores these constraints and discusses emerging solutions.

Entry: Responding to Market Needs

To date, most impact investors have focused their efforts on developing market scalars. For example, more than 90 percent of the assets under management for impact investing is invested in “post-venture” or scaling stages (J.P. Morgan 2014). A similar situation exists in financial inclusion, with the majority of DFI and MIV funding going to FSPs serving the lower-income segment and whose business model has been proven a long time ago.¹⁰ In contrast, there is an increasingly widespread view that investments in market innovators as well as market infrastructure businesses are insufficient; yet such businesses can also make significant contributions to building more inclusive markets.¹¹

With limited revenue or high costs, the entry decision for start-ups and the investor’s risk/return trade-offs are different than for scaling businesses. Identifying the right business model for market infrastructure businesses can be even more challenging because of the public good role they often have, and not all forms of services can be easily commercialized. Even if these businesses are able to generate revenues, profitability may not even be achieved and investors may need to make a long-term commitment. For an equity investor, this means placing less emphasis on capital gains (which is rare).

Furthermore, it takes a lot of work to identify these investees: Accion’s Venture Lab reviewed over 1,000 applications to invest in 21 companies. Often impact equity investors are small companies with a limited number of staff, located in developed countries. Thus, they are usually predisposed toward identifying market scalars.

This mismatch between the capital most needed for market development and what is being offered is linked to the equity investors’ structures.

Private equity model more suitable for large investments. This model is often used to diversify investments by pooling funds with other investors to work with experienced fund managers and focus on specific investment objectives. In financial inclusion, this model is mainly used with MIVs, which provide approximately 60 percent of the equity funding to FSPs.¹² The compensation structure of an equity fund consists of a management fee based on the fund’s size and a “carry” formula for sharing profits between investors and the fund manager.¹³ Consequently, there is an incentive to create large funds with a relatively small number of less demanding investments. In contrast, innovative or market infrastructure businesses typically require relatively small investments and considerable hands-on support—hence the equity fund model does not necessarily create strong incentives for investing in these types of companies.

A variety of efforts are underway to make this model more conducive to financing start-ups. The high costs of identifying and working with small investees have been addressed in some funds by providing grants and larger management fees to the fund manager. Some funds address the high risks by including first-loss coverage with an investor or grant donor who agrees to bear first losses in an investment. Changing the compensation structure is another plausible adaptation, although not

¹⁰ It is important to note that comparing investment figures for market innovators, market infrastructure businesses and market scalars is not straightforward, because market scalars by definition typically require more funding. Furthermore, it is impossible to know whether more funding for market innovators and market infrastructure businesses would actually result in a larger number of successful businesses.

¹¹ This topic is discussed extensively in Koh, Karamchandani, and Katz (2012).

¹² Estimate based on the 2014 CGAP Funder survey and 2014 Symbiotics MIV survey.

¹³ Management fees vary from 1.5 to 3 percent; management fees of 3 percent are typically for small funds of under \$50 million. Management fees are typically reduced by 25–50 basis points after the investment period has ended. The carry formula is typically 80 percent for the investors and 20 percent for the manager.

one that was adopted by any funds covered by this research. For example, the management fee could be increased so that managers have a higher operating budget and can better respond to the needs of start-ups, quickly adapt to ever-changing market conditions, and attract human capital with the appropriate expertise. A variation on the theme of adapting the fund manager's incentives is the initiatives taken by some investors to divide the carry into a financial and a social component (GIIN 2011). This approach not only compensates fund managers for higher risks, but also can focus attention on the market development outcome. Some of these initiatives could also be applied to funds that specialize in market scaling investments as incentives for expanding their willingness to take risks, such as expanding proven business models to new geographies and products.

DFIs have limited appetite for risk. In addition to working through funds, DFIs also have an option to take direct stakes in businesses. As publicly funded institutions, DFIs' mandate is to provide longer-term capital to the private sector for investments that promote development. Their investments are best placed where private investors fail to invest sufficiently because of real or perceived risks.

In financial inclusion, DFIs have demonstrated that the risk associated with financing MFIs is lower than previously perceived, thus attracting more private capital to the sector. Now that private capital has been crowded in, DFIs seem well positioned to contribute to filling the gap in supporting the next generation of market innovators. A few DFIs are supporting innovation with DFS through equity investments. They often invest in early/growth stage companies that already have an initial track record with an investment size of \$2 million to \$5 million. Although they often provide patient capital, their incentive structure doesn't encourage a higher risk appetite to invest in seed and early-stage companies, and they are prone to disburse larger amounts of money either with large direct investments or through funds.

DFIs could develop other investment structures that better suit the needs of innovative businesses. They and other large direct investors, for example, could create innovation investment labs similar to that of

Accion Venture Lab that foster experimentation and promote new business models through active investing and governance. Comparing the performance of these alternative investment structures with innovation-focused private equity funds could help investors continue to refine the optimal approaches for financing innovation.

Governance: Be an Active Owner and Align Interests

Most DFIs and social investors recognize the importance of governance to affect change at institutional and market levels. Although they have dedicated substantial resources to improving the technical skills of board members, even the most experienced board member can fail if the investors have not created conditions for effective governance. In fact, recent evidence in microfinance suggests that DFIs and social investors are not fully capitalizing on the opportunity to use this key leverage point and strengthen FSPs' governance (McKee 2012).

Integrating market development considerations into the governance process is even more challenging than the well-documented challenges of corporate governance more generally. Shareholders and the board need to agree on objectives, appropriate metrics, and assessing progress. Unless the investors have explicitly agreed among themselves on market development or other objectives and can give clear guidance to the board, it can be extraordinarily difficult for board members to resolve these issues on their own. This can be particularly tough in scaling investments, when a new, less developmental investor joins an existing shareholder group that may not share the same vision for the institution.

A closely related question is to define the appropriate balance between what is good for the investee and what is good for the market; important trade-offs such as time and financial resources need to be discussed and agreed on. An example of a governance challenge is provided by a board decision that the company's CEO should create and lead an industry association to contribute to the market's development. This decision raises questions about how to estimate the various costs to the company's business and the potential benefits from the industry association, so that the trade-offs can

be assessed. The board should also consider how it will assess the CEO's success in creating the association and what it would do if the CEO were not successful. Achieving agreement on these types of issues can be a significant challenge for a board of directors.

Governance is such an important leverage point that it is important for equity investors to try to agree among themselves on their objectives for the investee and provide a clear mandate for the board. This would include their expectations for how much and in which ways the investee should seek to contribute to market development for financial inclusion; these expectations could also be embodied in a shareholders' agreement, as well as requirements for reporting on financial inclusion initiatives and results.

Exit: Often Deciding under Nonoptimal Circumstances

Exits can have an enormous impact on the investee and market development, and yet they are typically the leverage point over which the equity investor has the least control. The optimal exit from a market development perspective is one in which the new investor is committed to the investee's mission and contributes new resources, such as funding, experience, and ideas, to the next stage of the investee's development.

But when to exit can be a challenging decision. The ideal timing is when the investor concludes that its objectives have been accomplished, there are suitable buyers, and market conditions are appropriate for obtaining a fair exit price. These conditions do not always correspond with the time frame for the investment and can result in exits that are not optimal for the investor, the investee, and/or the market.

The private equity fund structure is a factor that can affect the timing decision. Although these funds often have extension options, the deadline for returning funds to the investors creates a maximum investment term. If a fund's maturity date coincides with negative economic conditions, its exit possibilities

will inevitably suffer. There is also a disincentive for early exits, even for successful investments, because the fund's fee structure is based on assets under management. A related question is how to time an exit when there are attractive financial returns and disappointing impact performance or vice versa.

Many funds have flexible maturity dates in practice, because investors can extend the life of a fund. But this also creates a shrinking management fee for a fund with only a few remaining investments. Adaptations could be made to the fund structure to facilitate exits, such as establishing longer-term and/or more flexible fund maturity dates to give fund managers more time to work productively with their investees.

Shifting the focus on investor returns from exit to ongoing dividend payments could be another approach to help with the exit decision. This model would reduce the pressure on exits and provide investors with more time to work with their investees; although, it would also reduce the ability of the investees to reinvest their profits for the benefit of their clients.¹⁴

That said, even if an investor has the possibility or flexibility to work with its investees within a longer time frame, staying too long can crowd out potential new investors. The decision to work with investees for longer terms requires careful balancing among what is needed for the business and encouraging investors to enter a market.

Another challenging exit decision is to whom to sell the shares. Social investors often put considerable effort into ensuring their right to select responsible buyers and sometimes require commitments from the buyers to support the investee's mission.¹⁵ However, if the choice of buyers is limited and there is no timing flexibility, the investor's options are limited as well. Public listings are a potential solution for large investments in countries with developed securities markets, but these conditions are rare. Such exits also create challenges of their own related to the dispersed ownership structure and the impact on governance.

¹⁴ For a summary of an ongoing project to research the use of dividend payments and other approaches for achieving liquidity see de Callejon and Campbell (2015).

¹⁵ Potential buyers can sometimes be discouraged by the right of first refusal conditions that investors sometimes use to protect themselves from sales by another investor to a buyer that is not acceptable to the remaining investors. These conditions can have the unintended effect of discouraging attractive buyers (as well as unattractive buyers) who do not want to go through an entire due diligence and negotiating process only to learn at the end that some of the existing investors will exercise their first refusal rights.

Finally, if an investor sells to a buyer who does not share the objectives of the other investors, it can create a challenge to maintain the initial mission of the investee. Tag-along rights¹⁶ can protect existing investors from having to work with an incompatible new investor, but they weaken the market demonstration and crowding-in impact of the investment. A right of first refusal¹⁷ option could turn out to be impractical if the potential new investor is able to pay a higher price than an existing investor can afford.¹⁸

Looking Ahead

The practical potential for impact investors to use their leverage in ways that result in more inclusive financial markets is exciting and capitalizes on their experience working with individual investees. However, to ensure effective implementation, additional work is required to overcome the challenges discussed in this Focus Note. We see a number of specific areas that warrant further efforts.

Coordinate with Other Investors and Stakeholders

Markets are in constant flux and impact investors don't necessarily have the adequate capacity and physical presence to understand and respond to changing needs quickly. Therefore, the more stakeholders coordinate by sharing information and working cooperatively, the greater the likelihood of success. The ideal scenario is for stakeholders to create a collective view about financial inclusion impediments and a shared commitment and plan for resolving them.

In cases where this scenario is not feasible, a less demanding but also important form of coordination is information sharing. This could be done through existing structures, such as industry associations, country- or market-level facilitators,¹⁹ or by working closely with other impact investors. A practical example of information sharing would be for investors to pool

their resources to outsource market research. Not only would this reduce research costs, but it also would give investors a shared information base for consultation. Impact investors could also commit to sharing information about problems and lessons learned from failures. While this is sensitive information that has to be managed carefully, the market development benefits of sharing the information could be extensive.

Engaging with regulators and policy makers can also make important contributions to market development. While individual investors often lack the time or resources to do so directly, and their efforts to do so can be perceived as self-serving, coordination can help bring together the collective views of investors and ensure that their practical experience is shared.

As referenced earlier, Caspian Impact Investment Advisers was able to leverage the work that FSG/MIM started in 2006 to test the investee market for affordable housing in India. FSG/MIM worked closely with key stakeholders, including donors, investors, and over 600 housing developers, to develop and promote the concept.²⁰ With growing interest, FSG/MIM helped the first developer get started, including selecting a site and incubating an affordable finance mortgage provider, among other initiatives. In parallel, Caspian raised funding to invest in this sector through its India Financial Inclusion Fund. It made several investments, including in the company incubated by FSG/MIM, to provide mortgages to low-income borrowers and played an active governance role. FSG/MIM eventually worked with the government on housing policy issues and publishing state-of-the-sector reports to share industry information; Caspian has consistently contributed to these reports and shared its views on affordable housing policy issues. The work of FSG/MIM, Caspian, and others to develop the affordable housing market in India has had a positive impact. More than 80,000 low-income homes have been purchased in India. Not only have several of Caspian's investees attracted second round financing

16 Tag-along rights give a minority investor the right to join the transaction and sell his or her minority stake in the company when a majority shareholder is exiting.

17 The right of first refusal permits existing investors to acquire shares before a third party buys them.

18 One topic that merits further consideration is the incentive structure for investment advisers who manage the exit process, which is typically related to the final sales price. This compensation structure clearly provides incentives for the adviser to focus on price at the potential cost of other factors, even if the price is not the seller's primary concern.

19 An independent actor that is close to the market and thereby able to monitor market developments on an ongoing basis.

20 FSG/MIM's work is described in Koh, Hedge, and Karamchandani (2014).

Box 2. Tracking indirect impact

Impact investors have been focusing on measuring the development impact of their investments to ensure accountability and to track progress. Important milestones have been recently achieved with the creation of social performance metrics (e.g., Impact Reporting and Investment Standards, Global Impact Investment Rating System, Social Performance Indicators for Microfinance, etc.). Investors are able to report on the direct social impact of their investees, such as the number of women or low-income households served by their investees.

Yet, another form of development impact deserves further attention by investors: indirect impact of firms that can have ripple effects on the market. Kubzansky and Breloff (2014) have identified three indirect impacts: (i) inspiring copycats, (ii) generating a competitive response from existing businesses, and (iii) focusing attention on previously unidentified market shortcomings.

The challenges with these indirect outcomes are that they often are unpredictable and difficult to discern even after the fact. However, if they can be identified, they can also create opportunities to generate

knowledge that can benefit the market and have potential spillover effects.

Accion Venture Lab is currently experimenting with several approaches for tracking indirect impact of its investments in start-ups and creating information to contribute to a sector-wide discussion about this topic. These approaches include the following:

- **Defining alternative pathways to scale**, by highlighting the first mover's role in a final successful outcome.
- **Making efforts to raise awareness and monitor "buzz"** to measure awareness and influence.
- **Focusing on the sector as well as the firm**, by measuring sector-level outputs in addition to firm-level outputs and laying the groundwork for understanding the possible links between them.
- **Tolerating different data at different innovation stages**, because impact will be reflected in different ways throughout the life of a project: for example, a start-up going from no clients to 1,000 may suggest a bigger impact than a larger firm adding 1,000 customers.

Sources: Kubzansky and Breloff (2014) and Breloff and Khosla (2014).

from new investors, affordable housing finance in India is now perceived as a market with potential.

Collaborate to Strengthen Market Infrastructure

Although the specific characteristics of infrastructure investment can make it impractical for many impact investors, market infrastructure is too important for the sector as a whole to ignore. Those that cannot invest directly should seek other ways to ensure that the appropriate infrastructure is created.

These activities may include working with industry associations to identify infrastructure needs and bringing these needs to the attention of the appropriate actors. DFIs could consider the example of the International Finance Corporation (IFC), which has fostered the development of credit bureaus and collateral registries by providing advocacy, grant funding, and expertise.²¹ Investors

can also collaborate with specific providers to ensure that their services better respond to needs and providers are able to monetize their offering.

Develop Market Development Metrics

Measuring impact is one of the biggest challenges when it comes to embedding market development objectives into equity investment strategies. Impact investors need not to be clear on what market impact they are seeking to achieve but also on how it can be measured and analyzed to determine whether a specific investment decision really did contribute to a market development outcome (see Box 2).

Given the challenges associated with measuring impact of individual investees, assessing market-level impact is more complex. Nonetheless, there are emerging efforts to define broader market-level measurement principles and standards, and investors can benefit from and contribute to these efforts.²²

21 For information on IFC's Credit Bureau Program see http://www.ifc.org/wps/wcm/connect/REGION__EXT_Content/Regions/Sub-Saharan+Africa/Advisory+Services/AccessFinance/Credit+Bureaus+Program/

22 CGAP is currently working with funders and industry experts to develop innovative and more complete ways to measure inclusive market development. For more information see <http://www.cgap.org/topics/impact-and-measurement>.

Organizations Interviewed

Accion's Frontier Investments Group
 Accion's Venture Lab
 Grassroots Capital Management
 Omidyar Network
 International Finance Corporation (IFC)
 Overseas Private Investment Corporation (OPIC)

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The author of this Focus Note is Estelle Lahaye. The author would like to thank Gail Buyske for her important contributions to the paper, including her thought partnership and support throughout this project. The author would like to thank staff at IFC, Accion's Frontier Investments Group and Venture Lab, OPIC, Omidyar Network, and Grassroots Capital Management

who shared their own experiences and insights. The author would also like to thank the following colleagues who reviewed the Focus Note and provided invaluable input: Mayada El-Zoghbi, Frederik Jan van den Bosch, Deborah Drake, Louise Moretto, Kate McKee, Olga Tomilova, Erin Scronce, Anna Nunan, and Barbara Scola.

The suggested citation for this Focus Note is as follows:

Lahaye, Estelle. 2016. "Leveraging Equity Investments to Build Inclusive Financial Markets." Focus Note 104. Washington, D.C.: CGAP, March.

ISBN 978-1-62696-076-3

