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FROM Blueprint TO Scale

THE CASE FOR PHILANTHROPY IN IMPACT INVESTING

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Executive Summary

There is growing interest in the role of market-based solutions in addressing the problems of poverty, through inclusive businesses that tap into the potential of the global poor as customers and suppliers — the so-called 'fortune at the Base of the Pyramid (BoP).'

Encouraged by the growth of microfinance, many promising new models are emerging. This has elicited a rush to the new field of 'impact investing'— producing social or environmental good as well as financial return — with hundreds of funds set up in just a few years and billions of dollars waiting to be invested.

But many investors are finding a challenging reality on the ground, as they struggle to find good opportunities to invest for impact. Why is that? **Will impact investors really be able to take new models for inclusive business all the way from idea to scale?** Meanwhile, philanthropic and aid funders are asking how they should engage with these market-based solutions. How should they harness the full potential of this early experimentation? **If impact capital is the key to scaling these solutions, what then is the role of philanthropy?**

Our research paints a clear picture: impact capital alone will not unlock the potential of impact investing. Because inclusive business pioneers face extreme challenges, truly realizing the *impact* in impact investing will require *more*, not less, philanthropy, and will need that philanthropic support to be delivered in new ways.

THE REALITY OF INCLUSIVE BUSINESS

Monitor's research in India and Africa, and Acumen Fund's decade of investing experience, provide an insight into the many challenges facing inclusive businesses. They sell to a hard-to-reach customer base with severely limited resources, and engage suppliers with limited capabilities. Their products are often in 'push' categories like preventive healthcare requiring high levels of awareness building and education, unlike 'pull' categories like mobile phones that consumers already desire. And these come on top of poor infrastructure and inefficient regulation.

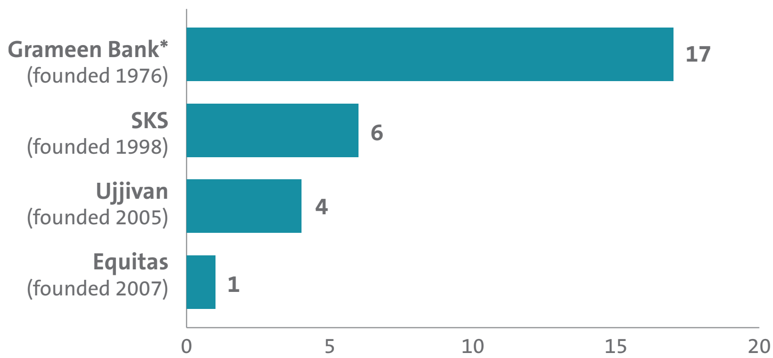
In response to these challenges, enterprises are innovating extensively and developing whole new business models tailored to the BoP market. **But the field is young and most of these models are still unproven.** A recent Monitor study of over 400 enterprises in Africa found that only 32 percent were commercially viable and had potential for scale, and only 13 percent were actually at scale.

For investors, this is a challenging environment. Thin and volatile operating margins, and long times to scale combine to produce low rates of financial return, but unproven business models in unforgiving environments are a very risky proposition. Small gains on a few successes are likely to be outweighed by heavy losses on many failures. Investors may also not be able to justify the heavy up-front expenditure needed to stimulate demand for new push product categories, or to improve supplier capabilities.

From a philanthropic funder's perspective, things look different. Faced with big problems and armed with limited resources, **funders are looking for innovations that offer improved effectiveness and sustainability.** Funders are also used to committing resources to 'social marketing' to change behaviors, or to training BoP workers and suppliers in new skills; the existence of business models to leverage those initiatives makes that spending all the more worthwhile. Funders have little issue with creating valuable public goods—such as business models, labor skills, infrastructure and customer education—so long as they lead to greater impact.

In these situations, philanthropic support can play a catalytic role in ways that investor capital cannot, as seen in the development of the microfinance sector. Now commercially attractive with billions of dollars of invested capital, microfinance was promising but unprofitable for many years. The sector received *$20 billion* in grants, soft loans and guarantees in its first two decades of development. This allowed early pioneers like Grameen to refine the model through many years of trial and error, providing the critical platform for later entrants to accelerate their progress towards break-even and investability.

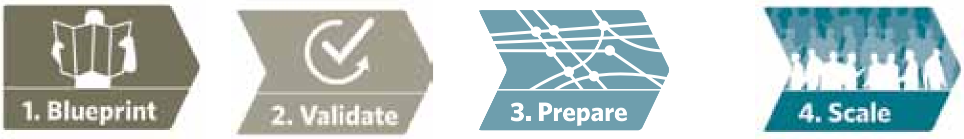
FIGURE 2: Time from Start of Operations to Operating Break-even Microfinance Lenders



Note: *Grameen was started in 1976 by Prof. Yunus using the money he received from a Fulbright scholarship as a project, the bank was formed in 1983.
Source: Mix Market data; *Small Loans, Big Dreams* by Alex Counts

THE PIONEER GAP

Firms pioneering new business models, particularly those serving the BoP market, face particular challenges. Monitor has identified the following four stages of pioneer firm development:



• Understand customer needs • Develop initial customer proposition • Develop business plan • Develop core technologies and/or product prototypes	• Conduct market trials • Test business model assumptions • Refine business model, technologies and/or product as required	• Stimulate customer awareness and demand • Develop supply chains, upstream and downstream • Build organizational capability to scale: systems, talent, plant	• Move into new geographies and segments • Invest in assets and talent • Enhance systems and processes • Exploit scale efficiencies • Respond to competitors

In the young field of inclusive business, most pioneers are still in the early ***blueprint***, ***validate*** and ***prepare*** stages, so this is where disproportionate support is needed. Unfortunately, few impact investors seem prepared to do this: Monitor's Africa research found that only six of the 84 funds investing in Africa or across regions offer early-stage capital. This is entirely rational. In the blueprint and validate stages here, unlike in the case of angel or venture capital investing in mainstream business ventures, there is limited potential for outsized financial returns within a timeframe that is acceptable to investors (typically five to seven years), in order to compensate for greater early-stage risk and small deal sizes. In the prepare stage, where new categories or value chains are being created, the initial spending on market preparation may not be recouped by the firm and its investors because much of the benefit flows to new entrants, or to customers or suppliers.

How will promising inclusive business models get to these later stages where they become investable if no one will support them earlier on in their journey? **We call this critical gap in support the 'Pioneer Gap'**, and we believe that this is a key factor constraining the availability of investment opportunities for impact investors. **Unless we address this pioneer gap, impact capital will fail to achieve its potential as a catalyst of powerful new market-based solutions to the problems of poverty.**

ENTERPRISE PHILANTHROPY TODAY

Philanthropic funding can play a critical role in closing this pioneer gap, through the practice of *enterprise philanthropy*. Already, this is the hidden catalyst behind a number of well-known inclusive business models. One example is M-PESA, the mobile payments platform developed by Vodafone with significant grant support from the UK's Department for International Development (DFID). Another is the clean-burning cookstoves sector, which has benefited from the sustained funding and advocacy efforts of Shell Foundation.

But this is clearly not grant funding in a conventional sense. Its immediate beneficiaries are typically businesses with a profit objective rather than nonprofit organizations, and this fact alone can be challenging for philanthropists. The focus is still on impact, but instead of paying for specific social goods or services, enterprise philanthropy aims to establish models into which return-seeking capital can be invested to drive scale. And it is interested in the impact created both by the pioneers themselves and by those that follow them.

Through a number of company case studies drawn from the Acumen Fund portfolio — in agriculture, energy, health and microinsurance — our report describes the practice of enterprise philanthropy today. **We take an in-depth look at both the successes *and* the setbacks** in these cases, and use them to illustrate four themes that characterize effective enterprise philanthropy: the Four Ps of Purpose, Profitable Proposition, Progression and Persistence.

Recommendations for Philanthropic Funders

1. **Consider moving into enterprise philanthropy through a range of approaches**
   More enterprise philanthropy is needed but there is a spectrum of potential approaches. Funders could support nonprofits or for-profits, and could deploy grant funding independently of, or in conjunction with, investor capital.
2. **Create and back new specialist intermediaries**
   To connect mainstream donors to the practice of enterprise philanthropy, interested funders should support the creation of new intermediaries for enterprise philanthropy.
3. **Embrace risk and acknowledge failures**
   This is an inherently risky endeavor; enterprise philanthropists must take risks with new models and markets, and be open about their experiences of failure as well as of success.
4. **Expand perspective to encompass markets and ecosystems**
   Unlike investors, philanthropic funders are uniquely placed to take a broad perspective and work across various points of the social capital market and ecosystem.

Recommendations for Impact Investors

5. **Collaborate with funders on new models and markets**
   Impact investors can work with enterprise philanthropists; clear communication of investment criteria would help guide early-stage pioneer firms – and their philanthropic supporters – to move towards investability.
6. **Align investment strategies with aims and expectations**
   Pursuing new business models to tackle the toughest problems affecting the poorest communities will not generate high risk-adjusted returns. Impact investors should be consistent in making trade-offs, and honest in communicating their expectations.

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