Impact Linked Financing Models: Balancing Purpose with Profits
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Need and potential for Impact Financing in India

While India’s population growth stands steadily at 1.23% annually, its progression on social parameters remains less optimistic. India still ranks 102 out of 135 countries in the Social Progress Index\(^1\); an index that ranks and analyses 133 countries with similar resources based on basic human needs, foundation of well-being and opportunity.

While the Indian government has set aside 6.7% of GDP for social expenditures, the market potential to serve the near two thirds of the population below poverty line also increases; their disposable income has increased to US $385 billion\(^2\), making it a viable business opportunity for market players to tap into. This large and growing market and the lack of adequate funds for public goods and services arguably led to the advent of impact investing in India.

Investing in impact: India’s story thus far

The year 2005 saw the emergence of social enterprises in India, with over 35% of the firms having their presence in Maharashtra. States like Kashmir and most of the north-eastern states have neither been able to access nor establish the social enterprise ecosystem within their states mainly due lack of infrastructure and poor law and order situations. On the other hand, Maharashtra, Karnataka, Tamil Nadu has seen successful implementation owing to better governance systems.

The investment in these social enterprises has been said to increase with the launch of India Inclusive Innovation Fund in 2014. The corpus has been pegged at INR 5 billion of which the Indian government contributes 20% and the remaining funds will be sourced from Banks, FIs, DFIs etc.

Figure 1: Description of impact enterprises across sectors

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Figure 2: Impact Investment between 2010 and 2015


\(^2\) McKinsey Global Institute, 2012
According to highlights from McKinsey’s 2017 report on the state of impact financing in India during the period 2010-2016, 424 impact investments worth $4.1 billion have been made. Cleantech accounts for 54% of the total capital invested followed by microfinance which accounts for 37% of the total amount invested during this period. The returns secured on these investments have been estimated at 10-12%; higher than the average 7-10% benchmark.

**Impact Financing Models: Diversifying Impacts**

Conventional impact investors, Private equity (PE) firms, Venture Capital (VC) funds, Development finance institutions (DFIs), CSR initiatives and international development agencies have been actively investing in the impact financing space. Off the 220 enterprises funded between 2000 and 2014, impact funds were involved in 136 deals in the first round of investment whereas mainstream investors were involved in 58 deals. However, the ticket size of the finance offered by impact investors continued to be small.

Access to initial as well as subsequent investment still seems to be a major concern for most social enterprises. While avenues exist, seeking other forms of social finance is now being encouraged given the demand-supply gap. Some of these models include,

- **Produce Purchase Agreements**: A concept similar to that of Power purchase agreement, the beneficiaries of the product/service agree to a contract with the provider for a predetermined period of time. The users only pay for what they consume, and the provider recovers the cost over a period of time.

- **Program Related Investments**: They are a form of impact investments aimed at achieving a predetermined objective and often result in return of the principal amount. While the return on investment is low, it allows for recycling of the capital for other social purposes.

- **Demand Dividend**: This is a debt vehicle that addresses two concerns; an investor’s want to exit and the beneficiary’s need for a flexible repayment plan. Developed by Professor Kohler in Santa Clara University, this form of financing allows for (i) 3-5 years moratorium for the entrepreneur, (ii) variable payment based on a percentage of free cash flow and (iii) fixed payoff amount for the investor.

- **Social Impact Bonds**: Social impact bonds allow for a government agency to define the expected outcome and contract the work to any organisation on that objective. Moreover, the government only pays when the goals are successfully reached; shifting implementation risk onto the more diversified investor. Pre-requisites to this instrument include but are not limited to, (i) government considering benefits of achieving this outcome, (ii) outcomes must be time bound and measurable, (iii) the intervention must have merit and should have been piloted and, (iv) instrument should not be used for core government services as any unsuccessful implementation could be disruptive. While this niche form of finance has found its way into the US and UK social impact market, it is yet to gain significant momentum here in India. In 2013, Dasra’s Educate Girls program became the first Indian organisation to use social impact bonds to launch the Pay by Results (PbR) programme under the aegis of Instiglio; a US based organisation. Currently, the programme is being piloted in 200 schools.

**What the future holds**

If India’s impact industry grows in tandem with the global impact investing landscape, assuming a growth of 20-24% globally, India is capable of attracting $6-8 billion of capital annually by 2025. With further tools of social financing identified and systems are put in place by this time, India will be able to harness the full potential that this field of social development has to offer.

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3 McKinsey report, 2017