Trends and Challenges of Impact Investing in Bangladesh

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Abstract
Impact investing has fundamentally changed the way enterprises engage in sustainable development. The traditional divide between profit enterprises seeking gain and non-profit organizations seeking social good is obscure as hybrid organizations bring profit-generating operations and social missions together. This contribution focuses on the state of impact investing in Bangladesh and secondary data discusses about trends and challenges of impact investing in Bangladesh. Actively seeking investment yield on both a financial and social return, impact investors are taking notions of socially responsible investment one step further with environmental impact.

Keywords: Impact Investing; Social Return; Environmental Impact

1. Introduction
In recent years, impact investing has become prominent on the global stage as an approach to deploy 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. Many investors and philanthropists are turning to impact investments as equally valid and in some cases even more effective vehicles for social change rather than pure charity. To complement this growing interest, a number of new innovations are emerging in the field, ranging from new financial tools to better metrics for social impact to new impact investing funds and investing in impact businesses can increase access to basic services such as finance, healthcare, education, clean water, and energy. Impact investing is a relatively new term and defines investing which gives both a financial and social return. This has huge potential in terms of leveraging the capital markets and in terms of reducing poverty. Bangladesh has the third most active impact investing market in South Asia after India and Pakistan. DFIs
have deployed over USD 830 million to date, while other impact investors have deployed USD 120 million.

2. Objectives of the Study

This paper has several related objectives:
1. To describe the impact investing;
2. To identify the active impact and impact-related investors in Bangladesh;
3. To explain trends and challenges of impact investing in Bangladesh.

3. Methodology of the Study

The study is based on secondary data report and data have been collected from research papers, sustainability reports from different organizations, published documents of the Bangladesh bank, newspaper, investors’ websites etc.

4. Theoretical Framework of Impact Investing

4.1 Origin and Drivers of Impact Investing

Prior to 2008, there had certainly been considerable innovation in the practice of investing for a mix of financial and social or environmental returns. The International Finance Corporation (IFC), for example, played a leadership role in some developing countries through lending to small businesses as a strategy to achieve broader development outcomes on the ground. For its part, the Grameen Bank became a world leader in scaling up micro finance programs for the poor in Bangladesh, and its approach was adapted and applied in dozens of other countries. In 2006, Grameen founder Muhammad Yunus shared a Nobel Peace Prize with Grameen Bank for his efforts. In another line of action, the nonprofit Acumen Fund was established in 2001 to mobilize capital for investment in social enterprises in Asia and Africa. These and many other examples constituted the platform on which recent efforts to construct the impact investing industry have been based.

4.2 Defining Impact Investing

“Impact investments are investments made in companies, organizations and funds with the intention of generating measurable social and environmental impact in addition to financial
return. Impact investing occurs across asset classes and financial products, including private equity and venture capital as well as debt” (The Global Impact Investing Network).

Impact investors aim to finance ventures with a core business model that addresses social or environmental challenges. The term “Impact Investing” was coined in 2007 in an initiative led by the Rockefeller Foundation, giving a name to various social investment methodologies that had been tried for decades.

Figure 1: The Impact Investing Process

4.3 Recent Growth of Impact Investing

The growing momentum of the global impact investing sector has resulted in additional capital invested through the impact methodology. Furthermore, we can see an increasingly diversified investor base as interest in impact investing grows beyond philanthropic foundations and Development Finance Intuitions (DFIs) who pioneered the field.

In the 2014 annual JP Morgan and the Global Impact Investing Network (GIIN) report of key impact investors, 125 fund managers, foundations, institutional investors, and development finance institutions were surveyed. These actors collectively managed US$46 billion worth of impact investments in 2013.

There are many contributing factors to the growth and global recognition the impact investing sector is receiving. Below are three drivers which have influenced recent development:

- Early evidence of the effectiveness and profitability of past impact investments, which increases the confidence of private sector actors to enter this sector in emerging markets
- Growing commitment of asset-owners and corporations to deploy capital in an
accountable, responsible, and transparent manner (for instance, as of 2014, 1,276 institutional asset managers, with combined assets of over US$45 trillion, have signed up to the UNPRI, up from US$4 trillion in 2006).

Increasing confidence by governments and philanthropists regarding cooperation with the private sector, after finding that capital deployed with positive intention is both effective and critical in catalyzing solutions for social challenges such as poverty, job creation, environmental challenges, and others.

Despite these growth trends, the sector represents only a tiny fraction (approximately 0.2 percent) of the US$210 trillion in global capital markets. To reach its potential, the sector should mature from its early experimental phase and new actors must find their way to participate in growing the volume of capital directed to impact investing.

4.4 What Kinds of Impact?

The question of what kind of impact typical impact investors aim to achieve varies greatly from one investor to the other, based on the different preferences of each impact investor. In the context of this report, we generally refer to social impact as improvements in people’s quality of life through improved access to infrastructure or basic services, such as energy, healthcare, education, housing, and clean water. In addition, social impact objectives tackle human development challenges, including entrepreneurship development, global food security, gender equality, job creation/youth unemployment, and more. Environmental impact is generally understood as initiatives that will reduce Greenhouse Gas emissions (GHGs), address climate change challenges, or increase environmental sustainability (such as reforestation, conservation, and so on).

While the focus of this report lies in social impact targets, it is important to mention that there are vast environment and climate finance opportunities, especially given the new post MDGs 2015 Sustainable Development Goals, which will include environmental and sustainable development.

4.5 What Types of Financial Return?

Impact investors seek a wide range of financial returns, from market-rate to concessionary. Typical ‘market-rate’ impact investors view the risk-adjusted market-rate returns
on venture capital/private equity style impact investments at 25 percent. Other impact investors, however, target 3-15 percent return on investment (in equity investments), which are considered in global financial markets as ‘below market-rate’ returns.

![Figure 2: Social and Financial Returns](image)

5. Impact Investing in Bangladesh: The Supply Side

The impact investing market in Bangladesh is nascent, but, of the countries under study, it is the third-most active after India and Pakistan and is likely to continue to see strong growth over the next few years. The Bangladesh market accounts for 11.2% of the total capital deployed among the countries under study, has the fourth-largest number of active players, and has a number of investors scoping the market for possible entry.

5.1 The Broad Impact Investment Market in Bangladesh

There are at least 15 impact investors currently active in Bangladesh with a total of USD 955 million in deployed capital, of which USD 834 million has been deployed by DFIs. Among these investors, there are nine funds (five investing only in Bangladesh and four...
regionally), four DFIs, and two foundations. These investors currently have more than 50 active investments. While most of these investments have been made by a few small private equity funds, the bulk of capital represents investments by DFIs in enterprises and banks and by microfinance institutions (MFIs). The section “Key trends of impact investing in Bangladesh” discusses in detail the emerging trends among these investors.

Beyond these impact investors, at least 14 impact-related investors have current investments in Bangladesh of about USD 744 million (Figure 4). Most of this capital has been provided as loans to SMEs through commercial banks. The remaining investors are funds and a small group of high net-worth individuals (HNWIs). While commercial banks have a clear primary focus on financial returns and, for now, see their impact as a by-product of their lending activity, some of these other impact-related investors may develop a more explicitly intentional strategy, as they seek to formalize their impact measurement and articulate clearer non-financial objectives. As many of these investors have focused on gaining a foothold in the market and achieving financial sustainability, impact intention has not been a core focus to date, but this is likely to become clearer over time.

Figure 2: Total capital deployed by ring, Bangladesh

![Figure 2: Total capital deployed by ring, Bangladesh](image)

Investors of the same type (DFIs, foundations, etc.) are largely concentrated within the same ring, with the exception of fund managers that appear in both rings. All DFIs and both foundations are impact investors, whereas commercial banks, three Bangladesh Bank funds, and one group of HNWIs are impact-related. There is more diversity among fund managers, which are found in both rings.
5.2 Active Impact and Impact-Related Investors in Bangladesh

There exists a diverse range of investors operating in Bangladesh. A range of players are active in Bangladesh as either impact or impact-related investors, including funds, DFIs, foundations, HNWIs and family offices, diversified financial institutions and banks, and the Bangladesh Bank, which, while being primarily the country’s central bank, also manages three funds.

Funds are the most common type of investor currently. There are 12 active funds in Bangladesh—seven of these funds are only making investments in Bangladesh, while the remaining five are regional with capital deployed in other countries. Ten of the 12 are private equity (PE) funds and two are venture capital (VC) funds. PE funds are backed by a range of limited partners (LPs), mostly DFIs but also foundations, HNWIs, and family offices. The three VC funds are investing off their own books with capital invested by the general partners. Of these funds, nine are impact investment funds while three are impact-related but invest in relevant markets.

DFIs are responsible for the largest portion of impact capital through investments directly in enterprises. Currently, four DFIs have nearly USD 834 million of investments in enterprises, primarily in information and communication technology (ICT), energy, manufacturing, financial services, and agro-processing. DFI investments account for 87% of the capital deployed from impact investors. Details on DFI investment preferences are discussed further in the section “Key trends of impact investing in Bangladesh.”

DFIs (and one multilateral donor) have also provided USD 739 million in debt and guarantees to banks for SME loans. An industry-wide liquidity crisis in 2011 prompted four DFIs to provide capital to seven banks, earmarked for SME loans. One DFI and one bilateral donor have also provided funding to the Bangladesh Bank for SME lending through commercial banks, and an estimated USD 153 million has been loaned through these funds.

About 94% of the capital originates with DFIs through their direct investments into enterprises, guarantees, and indirect investments (anchoring funds and backing commercial SME loans), and given this sizeable role in the impact investing market, DFIs are driving trends across the space.

DFIs are also driving trends beyond capital, often setting benchmarks for defining and measuring impact and advocating pro-investment policies. While many trends in the placement
of capital discussed in depth throughout the Bangladesh report are driven by the substantial DFI spending, investors are also looking to DFIs for impact definitions and measurement standards. In Bangladesh, DFIs have identified job creation and economic growth as core impact goals, and this has led them to focus their activities on high-growth sectors. DFIs are also using their legitimacy to advocate for pro-investment policy changes within the government. For example, one DFI is working with policymakers to address the lack of understanding about venture capital and private equity in order to develop stronger regulatory frameworks that make Bangladesh more appealing to both PE and VC investors. DFIs have also been advocating for the loosening of a three-year lock-in period for investors following an initial public offering (IPO).

Only two foundations are currently active as investors, but foundations are also providing business development services. While only one domestic foundation is providing debt financing to SMEs and one international foundation has made an equity investment, foundations have been active in offering technical assistance to business managers, discussed further in the section “Enabling impact investing: The ecosystem.”

HNWIs are likely a large source of start-up capital, most of which is provided informally; foreign HNWIs have backed a few funds, and at least two family offices are scoping the market. Family and friends are the primary source of seed capital for young entrepreneurs. A number of successful Bangladeshi entrepreneurs have also provided start-up capital. In most cases, these investments are made without any formal documentation or pre-set timelines, and due to their informality, it is difficult to scope the exact size of this market. However, most players in the market estimate this capital to be substantial. Beyond this, only a few formal domestic HNWIs offer capital as angel investors. Foreign HNWIs have backed impact funds, but typically in small amounts. At least two foreign family offices have been in talks to back a local fund.

Institutional investors largely operate on a commercial basis as lenders, but seven banks have portfolios targeting lending to SMEs and women-owned enterprises. Seven banks have received capital from DFIs that has been earmarked for SME lending. Banks are also lending to SMEs in priority sectors driven by government mandate rather than by impact intention.

6. Key Trends of Impact Investing In Bangladesh

The following section examines trends among impact investors, the “core” ring of
investors under study. The figures quoted in this section refer only to this set of investors, who collectively have about USD 955 million currently deployed. Given the sizable amount of capital deployed in Bangladesh, we see interesting trends emerging around impact investor preferences in terms of instrument, growth stage and deal size, and sector.

*Table 1: Types of impact and impact-related active investors in Bangladesh*

<table>
<thead>
<tr>
<th>Type of Investor</th>
<th>Estimated Number</th>
<th>Detail of investors in Bangladesh</th>
</tr>
</thead>
<tbody>
<tr>
<td>Funds and fund managers</td>
<td>12</td>
<td>Ten private equity funds and two venture capital funds testing the market with equity and quasi-equity investment</td>
</tr>
<tr>
<td>DFIs</td>
<td>4 DFIs and one donor</td>
<td>Drivers of market trends through both large, direct investments into enterprises (mostly debt to mature stage companies), as well as indirect investments (acting as LPs of funds or providing debt capital to banks for SME lending)</td>
</tr>
<tr>
<td>Foundations</td>
<td>2</td>
<td>Limited number of players in the impact investment market— one providing small amounts of debt financing to SMEs and one that has made an equity investment—but more active as business development Providers</td>
</tr>
<tr>
<td>HNWIs/Family offices</td>
<td>5-10 formal and many more Informal</td>
<td>Friends and family are likely one of the largest sources of seed funding, but most of these investments are made informally—with no documentation or timelines. Only a small number of HNWIs offering capital beyond this—as LPs or making direct investments—and at least two family offices looking to back a fund.</td>
</tr>
<tr>
<td>Diversified financial institutions/banks</td>
<td>7+</td>
<td>Seven banks lending to SMEs with debt provided by DFIs</td>
</tr>
</tbody>
</table>
Bangladesh Bank
(central bank of Bangladesh) | 3 funds | Managing three funds providing subsidized debt to banks making SME loans to targeted sectors or disadvantaged groups

6.1 Investor Mix
Among all the known impact investors, DFIs have deployed the largest amount of impact capital into enterprises. About 87% of the capital is deployed by DFIs. The remaining 13% has been deployed by fund managers and foundations.

*Figure 3: Impact capital deployed directly by type of investor (USD millions)*

Sources: Investor websites; Dalberg analysis

6.2 Instrument
Seventy percent of the total impact capital currently deployed has been through debt. The overall trend can largely be explained by the sizeable amount of capital flowing from DFIs. As we see in Figure 10, 79% of the USD 834 million invested by DFIs is through debt. This preference for debt is driven by risk aversion, regulatory barriers for using other instruments, and a greater familiarity with debt (particularly among business managers). In contrast, only about 9%, or USD 10 million, of capital from non-DFIs is structured as debt.

Equity and other instruments are being tested in small amounts by all types of investors, but are the most common type of instruments for non-DFI investors. Instruments other than debt make up about 17% of the known capital among impact investors. As seen in Figure 7, equity is
the most common instrument used, outside of debt. While DFIs have made equity investments worth USD 51 million (or about 6% of their investments by value), it is the non-DFI investors that are primarily exploring instruments beyond debt. About 91% of the non-DFI capital has been deployed through equity, quasi-equity, or deposits. This is largely driven by a single large domestic fund that has made nearly USD 100 million in equity investments.

Figure 4: Impact capital deployed by instrument (USD millions)

Sources: Investor websites; Dalberg analysis

In general, both investors and entrepreneurs express that debt is preferable given their needs and expectations. Investors, unsurprisingly, are looking to minimize their risks in the nascent impact investing market of Bangladesh, and debt allows them to assume less risk than other instruments. While one may expect early and growth stage entrepreneurs to seek equity investments, as these are often appropriate for their stage of growth, entrepreneurs tend to be more familiar and comfortable with debt structures and are reluctant to give up stake in their company. Many business owners do not recognize the value of instruments beyond debt and are unaware of the risk mitigation that equity structures can allow.

Regulatory structures surrounding equity investments, particularly those around exits and legal protection of the investor and investee, also fuel the preference for debt. The regulatory process for exits through IPO is unclear, and investors face a three-year lock-in of their investment following a public listing. Investors and investees are also uncertain of the legal framework for addressing disputes that might arise.
6.3 Growth Stage and Deal Size

Mature companies have received most of the known capital, as these companies can absorb larger amounts and meet the operating requirements of the investors. Mature companies are attracting most of the capital from both DFIs and non-DFI investors for two reasons. First, only mature companies are of a size capable of absorbing the amount of capital that many impact investors look to invest in deals, i.e., typically more than USD 1 million. Second, mature companies have an established operating history, are legally registered, and keep (at least partially) accurate financial records—all important requirements for investors. However, there is some concern that the pipeline of attractive opportunities in mature companies is limited. Investors scoping the market have suggested that the few large funds operating in Bangladesh have already taken the “low hanging fruit” of desirable investments, and hence, impact investors, finding it more difficult to secure investments in mature companies, are expected to begin exploring investments in earlier growth stages. Further, as VC funds continue to explore the market, it is likely that capital will be more diversified across different business stages.

6.4 Sector

The sectors receiving most of the impact investing capital are high-growth sectors such as ICT, manufacturing, and energy. Investor confidence in these sectors is high due to strong historical performance and future growth prospects.

Figure 5: Impact capital deployed per sector

Sources: Investor websites; Dalberg analysis.
Both ICT and energy have been identified as government thrust sectors, further driving interest in these areas. The high-growth sectors are appealing because of their potential to both provide financial returns and help meet the investors’ impact goals, as these sectors are likely to generate jobs and stimulate economic growth (which, as will be described later, have been identified by DFIs as the core impact objectives).

7. Challenges Facing Investors Deploying Impact Capital in Bangladesh

While impact investors are fairly optimistic about Bangladesh due to political stability, GDP growth, and demographic trends, there are still significant challenges that dissuade investors from entering the market.

1. Difficulty in raising funds: For asset managers, the key challenges at the entry stage have been the difficulty in raising funds and the regulatory limitations surrounding domiciliation. Nearly all Bangladesh-specific funds have had difficulty in raising capital, with only one fund successfully closing after meeting its target. Most fund managers would like DFIs to act as LPs, with seven of the eight funds (six active and two scoping) currently or previously approaching DFIs for funding. While DFIs have backed two funds and committed capital to others scoping the market, securing additional co-investors has been a challenge for fund managers. A part of this challenge has been scale; DFIs typically require their investment to be both fairly large (e.g., USD 20 million) and only a portion of the total fund (usually 25%–30%). Therefore, large amounts of additional capital need to be raised, but this has proved challenging. Only one fund has successfully raised its target capital, with many others closing well below their targets and some unable to raise sufficient capital to launch the fund. In addition to difficulties in raising funds, fund managers face regulatory issues around both overseas and domestic domiciliation of equity funds.

2. While pipeline development is a challenge, issues can be overcome if investors (whether asset owners or fund managers) can develop networks and establish a local presence. Early funds have taken the “low-hanging fruit” in the market, as only a few companies are currently structured and registered appropriately for investment. As a result, fund managers must invest quite a bit of time scoping for investment opportunities. Many fund managers have started developing a local presence, and partnerships are developing across funds to leverage strong networks.
3. Sourcing investment opportunities: Another challenge facing the impact investing community is how best to deploy capital into projects or ventures with high potential for social, environmental and financial return. Surprisingly, the supply of capital appears to be higher than the demand for capital. Many funds end up competing over the same high-potential investments. This may seem to suggest either a lack of good social ventures looking for money or a lack of social ventures with returns sufficiently high to attract investors. The challenge is not the supply of social business ideas, but the ability of these mostly small and informal ventures to express their ideas in business plans and pitches that meet the requirements of potential investors. Social entrepreneurship and social venture accelerators are still nascent in Latin America, and until more businesses professionalize, excess capital will continue to chase too few opportunities.

4. Difficulty in measuring impact: Measuring the financial performance of investment funds is very straightforward. Figuring out the right impact metrics for social and environmental returns is less easy, since each investment project addresses a distinct set of social impact issues, among them housing shortages, education quality, and poverty and so on. Further, not all value created by impact investments can be easily measured and compared; for example, how do you measure improvements in quality of service provision? In addition, it is not completely clear that the same metrics could or should be used across the globe. Finally, the metrics that do exist—IRIS (Impact Report and Investment Standards) and GIIRS (Global Impact Investing Rating System)—focus more on monitoring and classification than on actually identifying the impact of the investments on the communities in which they are made.

Clearly, measuring social impact is difficult. Setting up randomized trials and extrapolating conclusions across investments, sectors or geographies may not make the best use of the funds’ precious and limited resources. Similarly, the impact measurement frameworks used for policy or government social service programs may not be applicable to the efforts of private portfolio companies. Finally, it is not easy to measure the indirect impacts—such as informing and inspiring follow on innovations—by the investments made.

Despite the difficulty of measuring impact, many funds do believe that the portfolio companies they invest in are achieving or exceeding the expected impact targets.

5. Finding suitable exit opportunities: Although uncertainty around exits makes it difficult for some asset managers to raise funds, active investors have not been deterred by exit uncertainty. All equity investors expressed a preference for exit through IPO. They expect the
greatest returns from public listing and are most familiar with this mechanism. Investors express hope that IPOs will be a viable option at the end of their investment periods, but believe that other options may be more feasible, such as owner buy-back and trade sales. Secondary sales are rare due to a limited number of senior funds.

6. Lack of supporting institutions: Another factor must be added to the above concerns: the obscure role that governments play in Bangladesh, both helping and hurting impact investors. Currently, most countries have no clear legal frameworks for blending social impact and for-profit organizations such as impact investment funds.

8. Findings and Recommendations

8.1 Findings

The impact investment in Bangladesh is in growth stage. The volume of impact investment should be increased.

*Figure 6: Challenges Facing Enterprises in Bangladesh (% of Respondents)*

Source: World Bank Enterprise Survey of 1,442 enterprises in Bangladesh, 2011

In order for this potential increase in impact investment to be realized, there are number
of perquisites that must be met. The most frequently cited perquisites to increase impact investing were increase information about the availability of impact investing opportunities and easier access to impact investing opportunities.

Investors expect to diversify methods and types of instrument they use to make impact investment.

Investors expect to increase the amount of investment in public equities, liquid debt as well as through funds and indirectly through advisor.

8.2 Recommendations

Strengthen the business case for large institutional investors, both public and private, to integrate non-financial factors into their investment decision-making, particularly to enhance risk mitigation.

Use education and research to encourage a move from individual deals to multi-investment portfolios, in which investors can hold both impact-first and financial-first investments.

Encourage foundations to continue to innovate by making the strategic and cultural shifts necessary to devote the full range of their assets to their mission.

Create new options by matching investor risk/return profiles with investee businesses that can generate measurable returns on both the financial and impact dimensions, as well as by supporting investor collaboration and deal syndication.

Accelerate the production and application of practical knowledge products, including research and tools, aimed at governments engaged in or considering support for impact investing through policies that develop the supply of capital, policies that direct capital, and policies that strengthen demand.

Work with educational institutions to design and launch professional development and graduate programs for current fund managers, for new entrants to the investor and intermediary segments of the sector, and for social entrepreneurs seeking investment.

9. Conclusion

Leadership was pivotal five years ago, when the term “impact investing” was coined at the first Bellagio convening that set off such a remarkable chain of events. As this review has
shown, much progress has been made in building the field of impact investing globally. Many tangible gains have been achieved. And there is still much to be done. To be sure, building an effective global industry is a long-term, complex and difficult task. However, this is precisely the time for the leaders of the impact investing field in Bangladesh to recommit to building a fully developed marketplace. It is especially important now for those leaders to expand their partnerships with peer champions in every corner of the globe, to create compelling new financial products for institutional investors, to strengthen the investment readiness of enterprises on the ground, and to demonstrate social impact where it matters most: for individuals, households and communities.

References


List of Terms and Acronyms

DFI: Development Finance Institution
ESG: Environmental, Social and Governance
GIIN: Global Impact Investing Network
HNWI: High Net-Worth Individual
IMF: International Monetary Fund
II: Impact Investing
IFC: International Finance Corporation
IE: Impact Enterprise
ICT: Information and Communication Technology
LP: Limited Partner
MDG: Millennium Development Goal
PE: Private Equity
SME: Small or Medium Enterprise
SRI: Socially Responsible Investing
VC: Venture Capital