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Impact investing: Purpose-driven finance finds its place in India

Private Equity and Principal Investors Practice September 2017

Authored by
Vivek Pandit
Toshan Tamhane

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Foreword

This report comes at a very opportune time, as impact investment is advancing towards a tipping point. Reliable information is needed in order to inform investors, businesses, entrepreneurs, philanthropists, not-for-profits, and governments about the role they can play in using impact investment to improve lives and the environment.

In 2000, the UK's Social Investment Task Force, which I was privileged to chair, concluded that financial innovation would be required in order to unlock funding for social entrepreneurs in a similar way that venture capital unlocked it for high-tech entrepreneurs.

Now, 17 years later, impact investment is clearly that innovation. If we measure social and environmental outcomes, we can optimise risk, return, and *impact* in our business, investment, and employment decisions. By optimising these three dimensions, we release private capital to address great social challenges in fields including education, health, poverty, and the environment, bringing solutions at a scale and speed that without this capital, governments and philanthropy simply cannot match.

In a recent article, penned following the success of the world's first Social Impact Bond launched in 2010, Gordon Brown, former UK Prime Minister and Chancellor of the Exchequer, eloquently conveyed the importance of impact investment. "Big ideas are few and far between…. Progress usually occurs incrementally, bit by bit. But sometimes a big idea—even one that starts modestly—can thoroughly transform our view of what is possible."[1]

In this important report, McKinsey presents valuable evidence about impact investing, dispels popular misconceptions about the field, and offers a framework for thinking about and implementing impact investment both in India and across the world. It brings us one step closer to changing our whole system's capital flows, directing them to deliver competitive market returns and an improvement in lives and the planet.

Sir Ronald Cohen,
Chair, Global Steering Group on Impact Investment

1 Gordon Brown in *Financial News,* 1 August 2017, www.fnlondon.com.

Preface

Rising demand for socially responsible and purpose-driven finance has resulted in new ways of putting capital to work the world over. In the past decade, what is now known as "impact investing" has challenged the long-held view that social returns should be funded by philanthropy, and financial returns funded by mainstream investors.

The global market for impact investments will grow to US $300 billion or more by 2020,[2] according to the Global Steering Group on Impact Investing, which in 2015 succeeded a task force set up by the G8. That is still a fraction of the total private equity assets under management, estimated at about US $2.5 trillion in 2016.[3] Companies, banks, venture capitalists, and private equity firms have entered the arena. These investors are bringing scale to what was earlier considered a niche, underlining the fact that they see it as profitable for themselves and their clients. As mainstream investors enter, the dialogue is shifting rapidly from impact investing to "investing for impact". Investing for impact makes good business sense as industry leaders realise customers and employees respond favourably to institutions that generate returns to society, lowering risk and enabling superior returns to capital.

India is fast becoming a test bed for many of these activities. Between 2010 and 2016, India attracted over 50 active impact investors, who, along with mainstream investors, poured in more than US $5.2 billion.[4] About US $1.1 billion was invested in 2016 alone. We hope this report will give readers a sense of how impact investing is developing in India, and debunk some myths that have long surrounded these investments.

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2 David Bank, "Steering impact investing toward a 2020 tipping point", Impact Alpha, 6 July 2017, https://news.impactalpha.com/steering-impact-investing-toward-a-2020-tipping-point-e6008f743d3d.

3 Private Equity and Venture Capital Report, 2017, Preqin.

4 IIC members' survey; VCCEdge; McKinsey analysis.

IMPACT INVESTING in NUMBERS 8

BILLION
US $5.2

Cumulative investments in the past six years

45%

of the impact investments happen in emerging markets

14%

Impact capital deployment CAGR

All figures for India unless specified

YEARS
4.9
Average
holding period

11%
Weighted
average IRR

MILLION
60-80
Annual beneficiaries

62%
Impact investment deals
seeded by impact investors

48%
Capital infused by
mainstream funds

The idea of impact: Introduction

The changing relationship between private capital markets and the wellbeing of society is a topic of much research around the world. The Global Social Impact Investment Steering Group, a taskforce set up by the G8 in 2015, predicts that the 20th-century approach to investing, based on risk and return, will be replaced by a new model built on risk, return, and impact.[5]

Impact investments seek to create social or environmental benefits, directing capital to enterprises that accomplish impact goals, which traditional business models cannot. While investors looking to effect social change through the power of markets have long used strategies based on socially responsible investing (SRI) and environmental and social governance (ESG), impact investing represents a quantum shift. In impact investment, social and environmental considerations are not lenses for rejection of opportunities; they are front and centre in the decision-making criteria for investors.

India is a natural test-bed for impact investments, with high social need and strong capital markets. As one of the two fastest-growing large economies in the world, India's GDP expanded at 7.9 percent in 2015–16, to US $2.1 trillion.[6] Poverty is on the retreat; the official poverty ratio declined from 45 percent of the population in 1994 to 22 percent in 2012.[7] However, a large part of the population in India remains underserved: 500 million people lack secondary education or skills training, 300 million people lack electricity, and 120 million rural households are unbanked.[8]

Defining impact investments and impact investors

The Global Impact Investing Network (GIIN) defines impact investing as investments made into companies, organisations, and funds with the intention of generating social and environmental impact alongside a financial return. For our analyses of the India market, however, we have defined impact investments in the following way, based on our conversations with limited and general partners:

1. Investments made in for-profit enterprises where management and investors have a stated mission of serving and measuring impact on underprivileged communities or the environment

2. Investments made via equity instruments (excluding debt and infrastructure project financing)

This definition of impact investments, while different from what GIIN and other industry associations have used, is agnostic to the source of capital, including investments by conventional private equity (PE) and venture capital (VC) funds. We define impact investors as those that explicitly invest for impact and are committed to dual bottom-line measures.

5 "Impact investment: The invisible heart of markets", 2014, Social Impact Investment Taskforce.

6 Press note: "First Revised Estimates of National Income, Consumption Expenditure, Saving and Capital Formation for the financial year 2015-16," Central Statistics Office Ministry Of Statistics & Programme Implementation, Government of India, January 2017, www.mospi.gov.in.

7 *India's path from poverty to empowerment,* McKinsey Global Institute, February 2014.

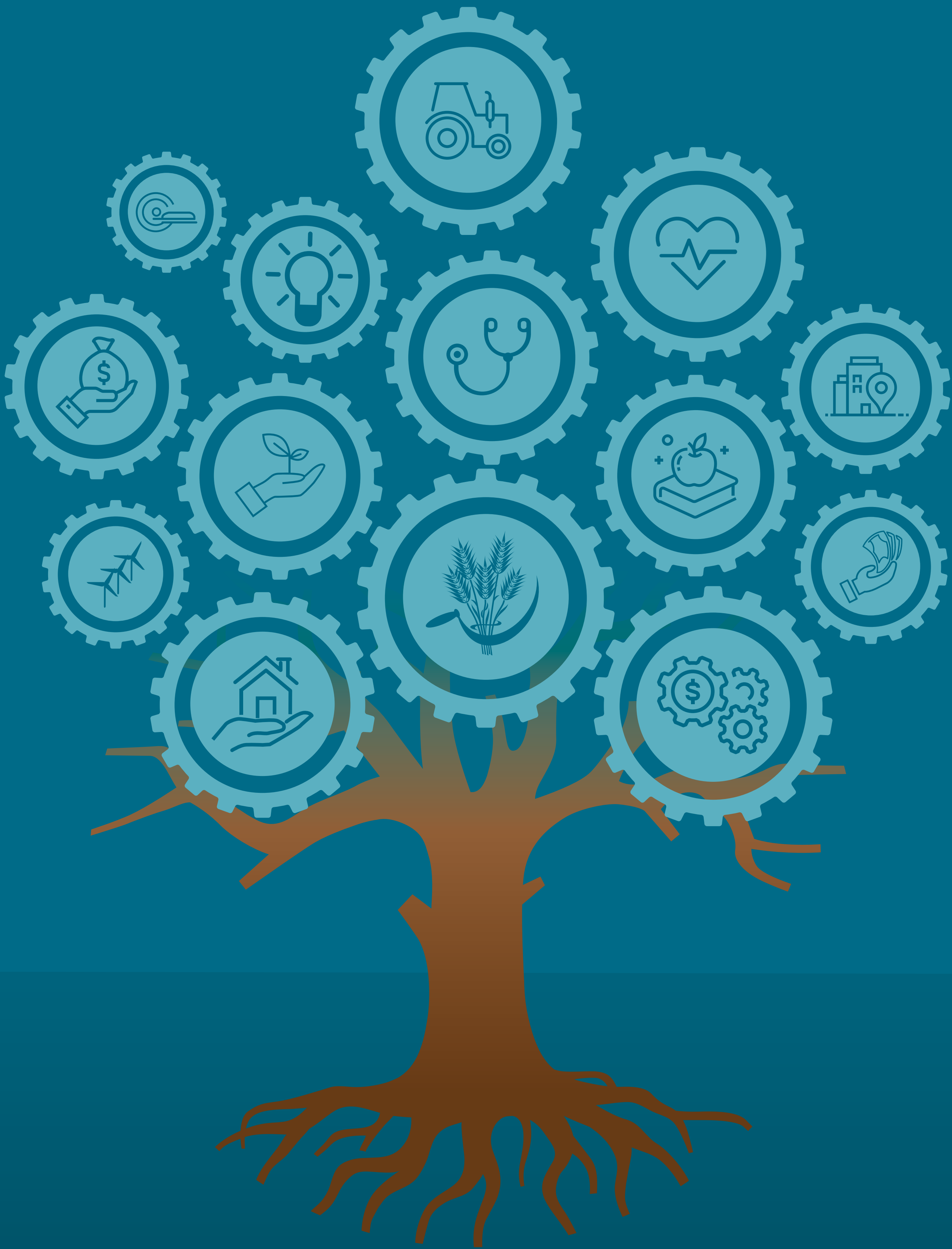
8 India's technology opportunity: Transforming work, empowering people, McKinsey Global Institute, December 2014.

Based on these definitions, we measure performance and intent at the enterprise level instead of the fund level, which also allows us to analyse performance at the sub-sector level and include all social impact investments regardless of investor origin.

Data sources and methodology

Our analysis and exploration of the future of impact investing in India in this report is based on exit data shared by IIC, the VCCEdge deal database, and proprietary access to impact investors and their investee companies. We also interviewed and surveyed 15 impact investing limited partners (LPs), 19 general partners (GPs), and 34 social enterprises.

Our global analysis is based on data from GIIN and JP Morgan Chase's annual impact investor surveys from 2013 to 2017.



At the frontiers of impact: The India story

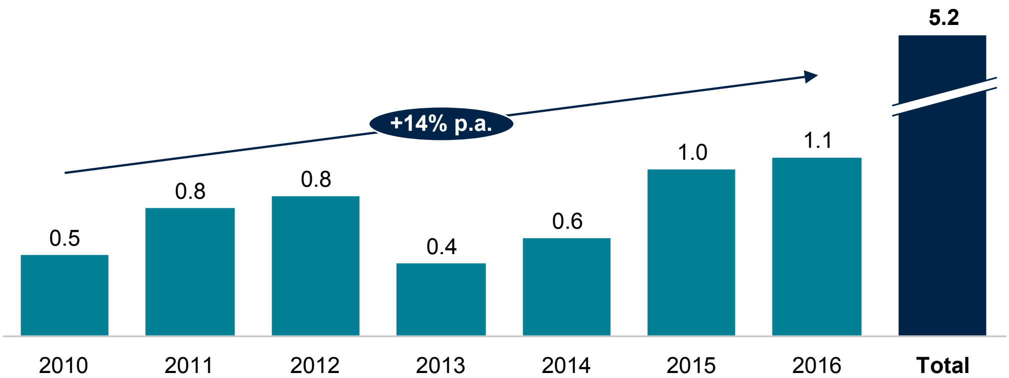
Impact investing can be a vehicle to fund, catalyse, and scale approaches that improve millions of lives. India is an opportunity-rich environment and is emerging as one of the most attractive markets for impact investing worldwide. High demand for investments is likely to continue as a result of a growing population, underlying economic growth, stable financial markets with a strong rule of law, combined with large unmet social needs.

Cumulative investment in impact investments in India since 2010 has been US $5.2 billion. In many ways, 2015 was a turning point, as investments crossed US $1 billion (Exhibit 1). Much of the growth has come from a doubling or more of average deal size, which rose to US $17.6 million in 2016, from US $7.6 million in 2010. The volume of deals has remained stable at about 60 to 80 a year, demonstrating the emphasis on scaling new models of impact.

Exhibit 1

Impact investing touched US $1.1 billion in 2016 with average deal size of ~US $17.6 million.

Growth in impact investments in India, Value of investments, US$, billion



	2010	2011	2012	2013	2014	2015	2016	Total
Number of deals	65	63	65	81	80	70	61	485
Average investment size (US$, million)	7.6	12.3	12.9	5.4	7.4	14.3	17.6	10.7

SOURCE: IIC members' survey; VCCEdge; McKinsey analysis

As impact investing in India has grown to a billion-dollar-a-year industry, investments have been supported by different types of investors, with high expectations of impact, varied expectations of risk and return, and vastly different strategies and portfolio approaches. These investors have persisted despite setbacks, such as those in the microfinance and clean energy sectors.

We observe four trends shaping impact funding in India.

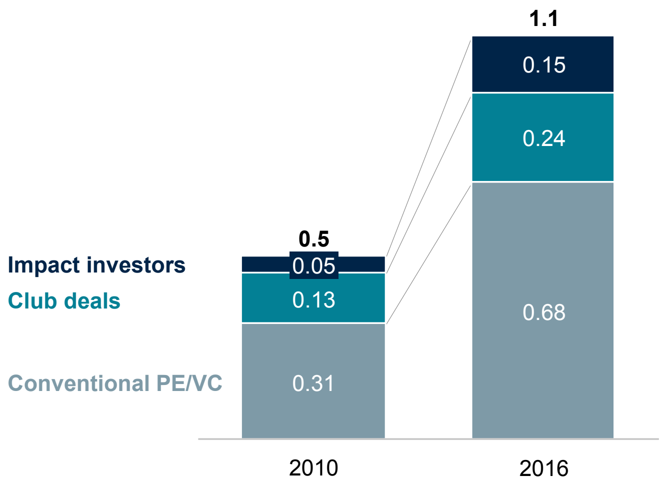
1. Diversified and complementary sources of capital

   Total investments have grown as a wider set of investors participates (Exhibit 2). Impact investors and conventional PE and VC firms bring critical and complementary skills to the table. While impact investors funded 65 percent of total deals by volume (including co-investment deals with traditional PE funds), these deals account for 52 percent of investments by value (Exhibit 15). Over the years, as business models in sectors such as financial inclusion and clean energy have scaled, investor confidence has grown and impact investors have started participating in larger deals along with traditional PE investors, resulting in more investment from club deals.[9]

Exhibit 2

Investments scale as impact investors seed and traditional investors scale.

Investments by investor type, Value of investments, US$, billion



SOURCE: IIC members' survey; VCCEdge; McKinsey analysis

2. Bigger ticket sizes

Data for the past three years show a spurt in deal size (Exhibit 3). Investments in clean energy dipped in 2012–13 as projects were deferred, after a delay in implementing tax incentives for green energy companies; the industry regained momentum after new policies were implemented.[10] Our analysis also shows three drivers of growth in average investment size. First, business models of several companies in healthcare, microfinance, and skills training have matured in recent years. This has increased their ability to absorb larger investments. Second, demonstrated profitable exits in the social sector are providing more liquidity to enterprises, and improving their ability to raise capital. Finally, an emerging collaboration between impact investors who de-risk business models and build capabilities, and growth PE investors that specialise in scaling and capital efficiency, is supporting impact enterprises' financing across their lifecycle.

3. Diversifying sector spread

At the start of this decade, investments in clean energy (wind, solar, and small hydro power generation) dominated impact investing in India. This changed sharply in 2013 as fund flows into clean energy slowed. Large investments in scale institutions in financial inclusion have offset some of this decline. Overall, the sector mix has changed. Clean energy amounted to roughly 40 percent of the deal value in 2014–16, declining from 60 percent in 2011–13, because of an increase in both volume and value contribution from microfinance as the sector became more mature (Exhibit 4).

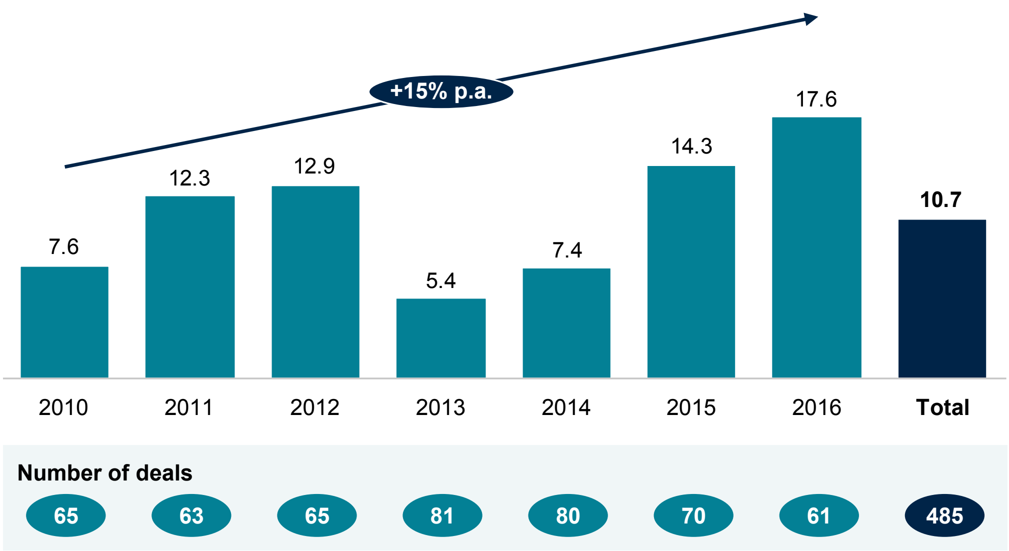
9 Refers to deals where impact investors and conventional PE/VC investors participate together.

10 *CRISIL Insight: Wind-energy sector to see Rs.650 billion investments in 3 years,* CRISIL, Jan 2015, www.crisil.com;

Exhibit 3

Average deal sizes rise as social enterprises scale and impact investing becomes mainstream.

Growth in impact investments in India, Average deal size, US$, million

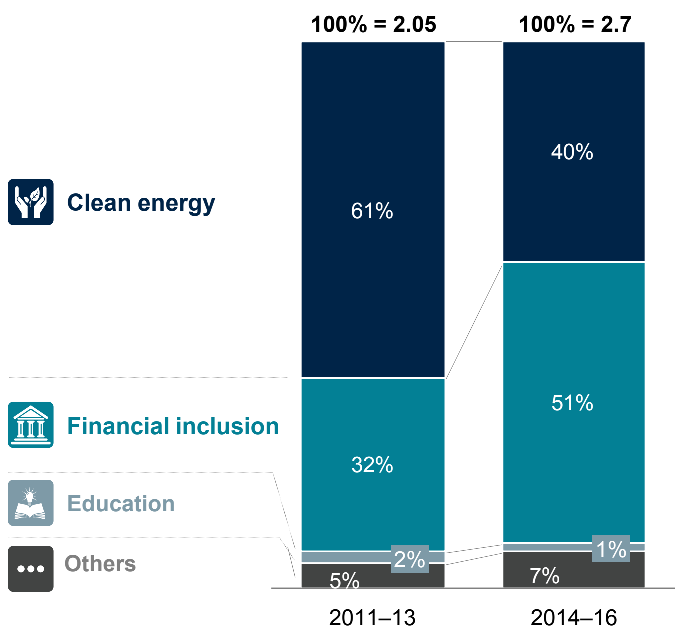


SOURCE: IIC members' survey; VCCEdge; McKinsey analysis

Exhibit 4

Impact investments are diversifying.

Split of deals by sector, Value of investments, US$, billion, %



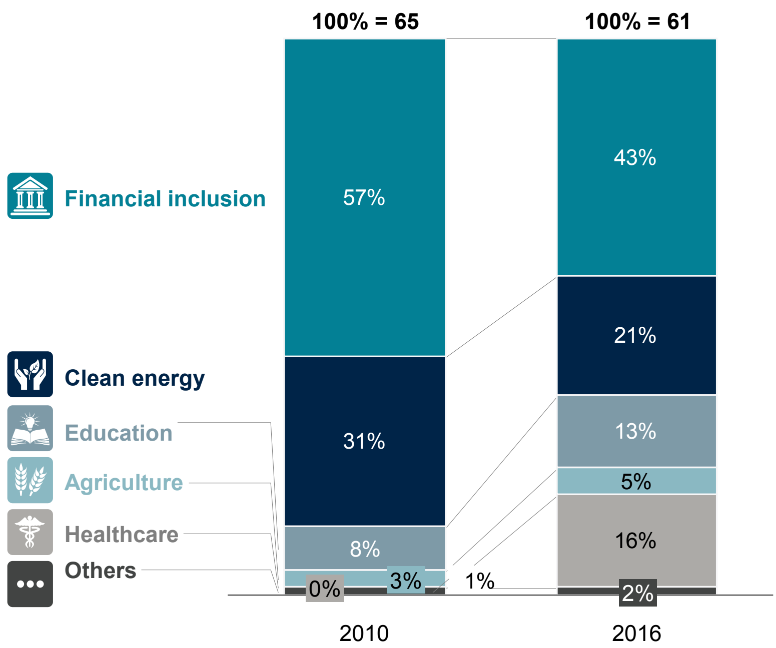
SOURCE: IIC members' survey; VCCEdge; McKinsey analysis

In terms of volume growth, too, there is increasing diversification. Investments in sectors such as education, healthcare, and agriculture have all grown during this period (Exhibit 5). Financial inclusion and clean energy accounted for 64 percent of the deals in 2016, compared with 88 percent of the total in 2010. This shows investors are finding investable business models and enterprises in sectors that were previously considered unattractive from a scale or returns perspective.

Exhibit 5

Volumes reflect diversity of sectors and their maturity.

Deal spread by sector, % of deals by volume



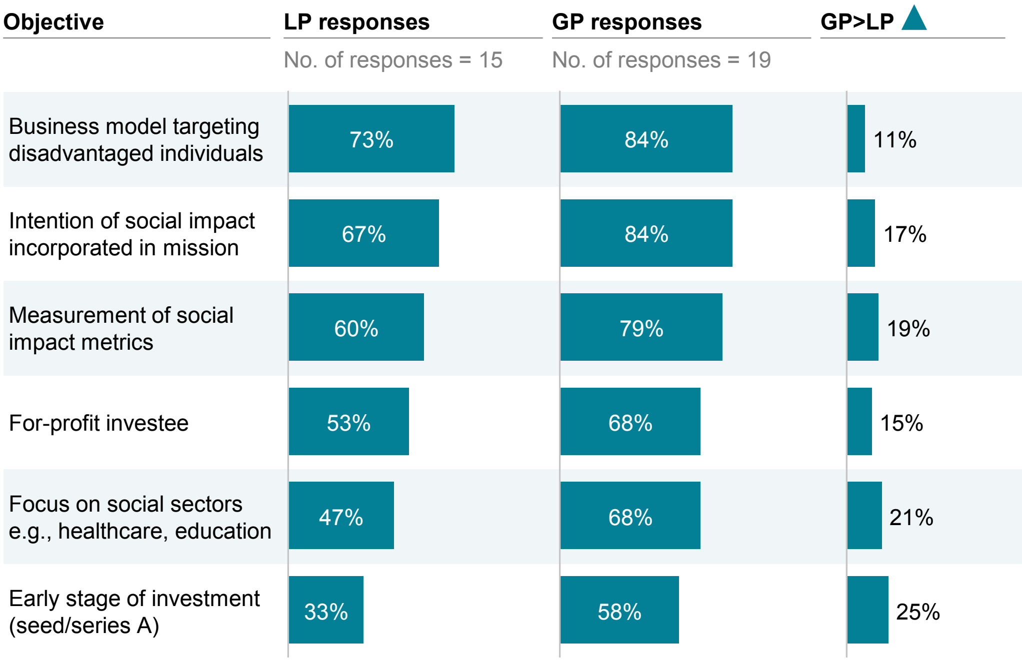
SOURCE: IIC members' survey; VCCEdge; McKinsey analysis

4. Investment objectives of GPs and LPs aligning

GPs continue to hold themselves to a high standard on the type of investments they make, and stages at which they invest. Even as GPs see the capabilities and business models of social enterprises mature, especially in sectors such as financial inclusion, they largely remain focused on earlier-stage investments. LPs appear less constrained by stage of investment or measurement metrics. Overall, as the industry matures and more exits and returns are realised, LPs and GPs appear more aligned on investment criteria than ever (Exhibit 6). For example, there is greater convergence on criteria necessary for social investment, adding to LPs' confidence.

Exhibit 6

LP and GP expectations converge on multiple investment objectives.



SOURCE: IIC members' survey; McKinsey analysis

Impact investors: Leading the way to profitable social investments in India

Impact investors are often the first institutional investor to enter a social enterprise, and have built several social industries from a nascent stage. They go through the pain of redefining business models of portfolio companies and in doing so, have strengthened them in recent years. Social investors are able to address and solve a variety of early-stage issues because of their in-depth understanding of sectors and capability building for entrepreneurs.

Impact investors have complemented mainstream investment in social and environmental sectors in India. Even as social enterprises gain traction from traditional investors, impact investors bring critical complementary value in three ways:

A. Impact investors invest early, de-risk, and catalyse growth

- Impact investors provide capital for unproven business models at early stages and across wider sectors and geographies that are underpenetrated by mainstream investors (for example, sanitation, water, and clean energy in rural communities):

  — Beyond financial inclusion and clean energy, impact investors held a broad portfolio and invested in over 100 deals across diversified sectors, twice as many as conventional PEs or VCs (Exhibit 15).

  — Impact investors have catalysed social sector opportunities as the first institutional participant in 62 percent of enterprises (Exhibit 14).

  Case example: *A high-risk investment by an impact investor paid off when it seeded a dairy company in an Indian state that had high demand for its products, but was not considered conducive to business by mainstream investors. The company now processes 40,000 litres of milk and milk products daily, sourcing from more than 10,000 farmers.*

B. Impact investors have a dual mission of social-environmental development and financial returns

- Mission alignment between social impact funds and social enterprises on the dual mission makes impact investors preferred investors for social entrepreneurs. Select investors, like foundations with a philanthropic background, provide greater flexibility of financial terms if the social impact thesis is sufficiently compelling. In many instances, this gives impact funds an edge in sourcing attractive deals.

  Case example: *A successful education-technology company present in 25 towns raised its first three rounds of funding exclusively from impact investors, resulting from the investee and investors' long-term impact focus and mission alignment from an early stage.*

- Impact investors are more flexible and allow social enterprises to grow and scale-up at a steady pace. They often take a long-term industry building view, rather than a short-term liquidation approach.

  Case example: *An outsourcing service provider that employs people with disabilities faced a lean period with unutilised capacity. Taking a long-term view, the impact investors supported the CEO, who was able to retain all the employees through the downturn. The enterprise generates revenue of US $4 million and is now profitable.*

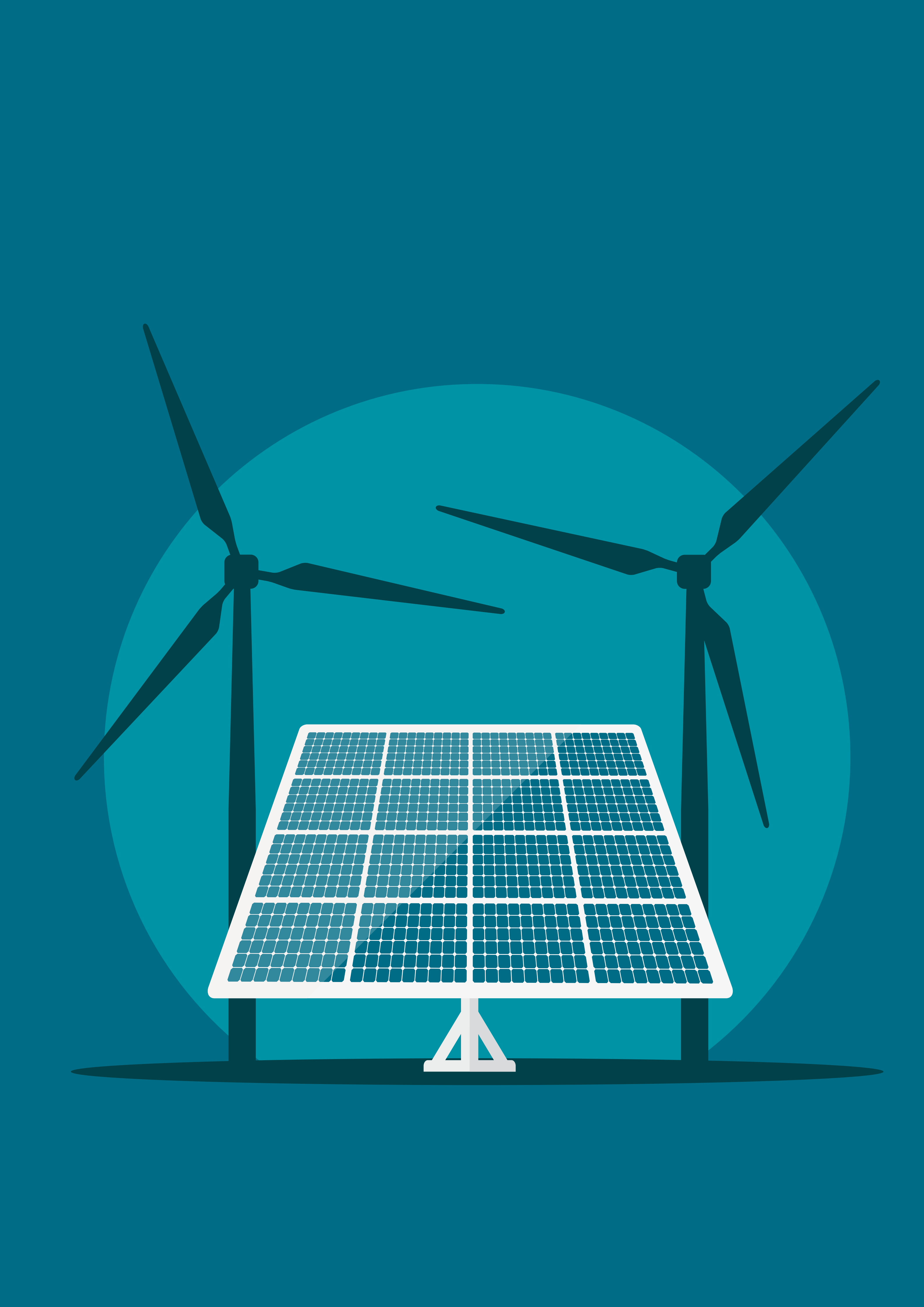
C. Impact investors build sector expertise and support enterprises

- Impact investors develop deep market expertise in social sectors. This allows them to spot opportunities in target sectors and guide entrepreneurs.

  Case example: *A food-processing venture sought funds from an impact investor with expertise in agriculture and livestock. An understanding of feed end markets, pricing dynamics, and disruptions from genetics was critical to support the investment thesis. Today the enterprise works with 2,000 farmers, with its product present in 22 Indian states.*

- They participate actively in capability-building measures for social enterprises, and partner with non-profits to utilise existing capacity and on-the-ground capabilities.

  Case example: *An impact investor built a sister organisation to support capability building for social enterprises. This organisation played an important role in coaching founders of many microfinance institutions during their early days, some of which have become quite successful.*



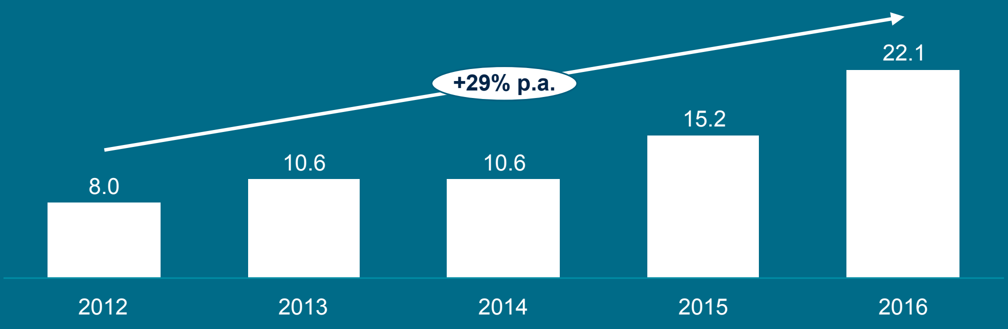
GLOBAL IMPACT INVESTING – EVOLVING TRENDS[11]

A In 2016, the value of annual global impact investments topped US $22 billion (Exhibit 7). Mainstream asset managers were quick to spot opportunities and are committing funds from their balance sheet as well as launching new funds focused on impact investing.[12]

Exhibit 7

Global impact investing growth.

Total impact investments[1], US$, billion



1 GIIN definition of impact investing.

SOURCE: J.P.Morgan and GIIN annual impact investor surveys 2013, 2014, 2015, 2016, 2017

B Several traditional investors, including TPG,[13] BlackRock,[14] and Bain Capital,[15] have launched or announced separate units for impact investments. Goldman Sachs Asset Management acquired an impact investment advisor Imprint Capital[16] and institutional investors such as Zurich Insurance, the AXA Group, and Australian superannuation fund, HESTA, entered the impact investment arena.[17]

C With growing activity and demand for investments, regulators are stepping up to recognise its importance in development and ease the flow of capital. The US government has made amendments to allow capital from foundations and pension funds to participate in impact investing.[18] Investors are asking for greater transparency and better ways to measure impact. Enterprises with a dual purpose of social good and financial returns are being recognised as a separate legal entity by regulators, like benefit corporations in the United States,[19] and "societa benefit" in Italy.[20]

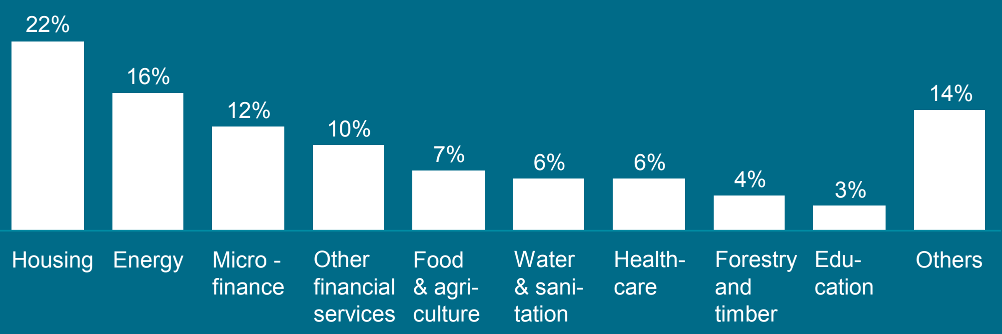
11 Impact investments as per GIIN's definition have been used for global industry.
12 "Impact investing must be more than a buzzword", *Financial Times,* October 2015, www.ft.com.
13 Andrew Ross Sorkin, "A New Fund Seeks Both Financial and Social Returns", *New York Times,* 19 December 2016. www.nytimes.com.
14 Jessica Toonkel, "Exclusive: BlackRock to ramp up impact investing", Reuters, 9 February 2015, www.reuters.com.
15 Ryan Dezember, "Massachusetts Ex-Gov. Patrick to Run New Bain Unit", *Wall Street Journal,* 13 April 2015, www.wsj.com.
16 Goldman Sachs press release, "Goldman Sachs Asset Management (GSAM) to acquire leading institutional impact investing firm Imprint Capital", 13 July 2015, www.goldmansachs.com.
17 "LeapFrog fund surges to $400m as global investors lean in", LeapFrog investments, 9 September 2014, www.leapfroginvest.com.
18 Michael Etzel, "New Regulations Boost Social Impact Investing", Stanford Social Innovation Review, 17 December 2015, www.ssir.org.
19 Social Enterprise Law Tracker: Status Tool—Benefit Corps., http://www.socentlawtracker.org/#/bcorps.
20 "Italian Parliament approves Benefit Corporation legal status", The Blog: Voice of the B Corporation Community, 22 December 2015, http://bcorporation.eu/blog/italian-parliament-approves-benefit-corporation-legal-status.

D As capital flows increase, they are increasingly diverse, even as three sectors—housing, energy, and microfinance, constitute half the total investments (Exhibit 8). Investments in these sectors have proliferated as they operate parallel to existing large-scale industries that traditional investors operate in and are familiar with.

Exhibit 8

Housing and microfinance have the high AUM due to mature business models in underlying industries; energy sector is growing as demand for clean energy increases.

Sectors by AUM, 2016, AUM split by sector, 100% = US $113.7 billion



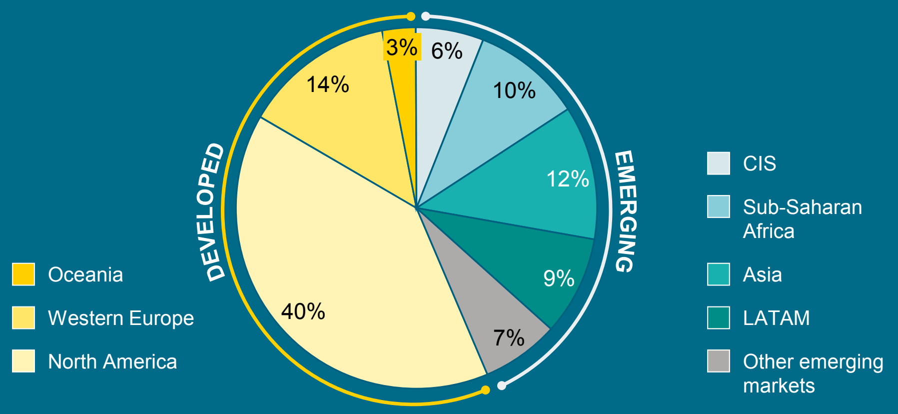
1 GIIN definition of impact investing.

SOURCE: GIIN annual impact investor survey 2017

Exhibit 9

Emerging markets account for ~45 percent of AUM, with Asia and Sub-Saharan Africa at 22 percent.

Impact investments by geography, AUM split by region; 100% = US $113.7 billion



SOURCE: GIIN annual impact investor survey 2017; McKinsey analysis

E About 45 percent of all impact assets are concentrated in emerging economies (Exhibit 9). This is a much higher proportion than in traditional alternative investing, and for good reason. There is a vast demand for social investments in emerging markets, which is largely unmet by governments. This paves the way for the private sector to provide social goods and services at scale. Asia is fast emerging as a hub for impact investors because of its high population density and strong human capital, which make it easier for enterprises to achieve scale.

Dispelling notions about investing for impact

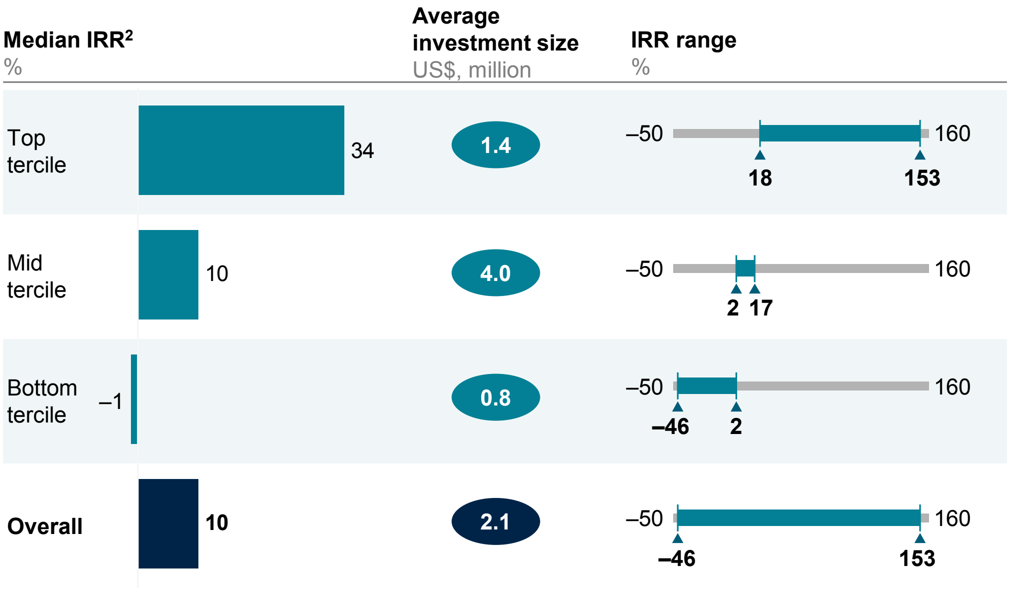
Impact investing still has a long way to go as investors continue to struggle with preconceived notions and biases. Our analysis has led to a few counter-intuitive insights.

Myth 1: Impact investing means lower returns

Impact investments in India have demonstrated an ability to employ capital sustainably, and also to meet the financial expectations of investors. An assessment of 48 exits between 2010 and 2015 shows that the investments produced a median internal rate of return (IRR) of about 10 percent (Exhibit 10); 58 percent of the deals either met or exceeded the average expected market rate of about 7 percent. It may come as a surprise that the top one-third of deals yielded a median IRR of 34 percent, clearly indicating that it is possible to achieve profitable exits in social enterprises.

Exhibit 10

Impact investment returns[1] have ranged from –46 to 153 percent with a median return of 10 percent.



1 Includes partial exit returns for stake sold.
2 Overall weighted average IRR is ~11%.

SOURCE: IIC members' survey; VCCEdge; McKinsey analysis

A sectoral analysis shows that financial inclusion stands out for profitable exits. Nearly 80 percent of the exits in financial inclusion were in the top two-thirds of IRR performance. Half the deals in clean energy and agriculture generated a similar financial performance, while those in healthcare and education have yet to catch up. With a limited sample set of only 17 exits outside financial inclusion, it is too early to evaluate the performance of the remaining sectors.

The correlation between size, volatility, and performance (Exhibit 12) is evident, allowing investors to select opportunities best suited to their skills and investment strategy. That volatility of returns decreases with increasing size of deal is not to be taken for granted either. It's an important outcome, an indicator that investors have expertise in seeding, growing, and scaling social enterprises and that they are able to manage risk effectively.

Exhibit 11

Exits by sector and performance tercile.

X Number of deals

IRR terciles	Financial inclusion	Health care	Education	Clean energy	Agri-culture
Top 1/3	12	0	1	2	1
Mid 1/3	14	2	0	0	0
Bottom 1/3	5	2	6	2	1

SOURCE: IIC members' survey; VCCEdge; McKinsey analysis

Exhibit 12

Returns[1] and IRR ranges by deal size.

Deal size range US$, million	Exited deals	Average investment size US$, million	Median IRR[2] US$, %	IRR range %
5+	5	13.06	8	–50 … 0 to 18 … 160
1–5	11	2.38	16	–50 … –39 to 49 … 160
0.1–1	17	0.45	12	–50 … –28 to 84 … 160
<0.1	15	0.02	2	–50 … –46 to 153 … 160
	48			

1 Includes partial exit returns for stake sold.
2 Overall weighted average IRR is ~11%. Weighted average IRR for deals >5M: 9%; 1M–5M: 14%; 0.1M–1M: 15%; <0.1M: 31%

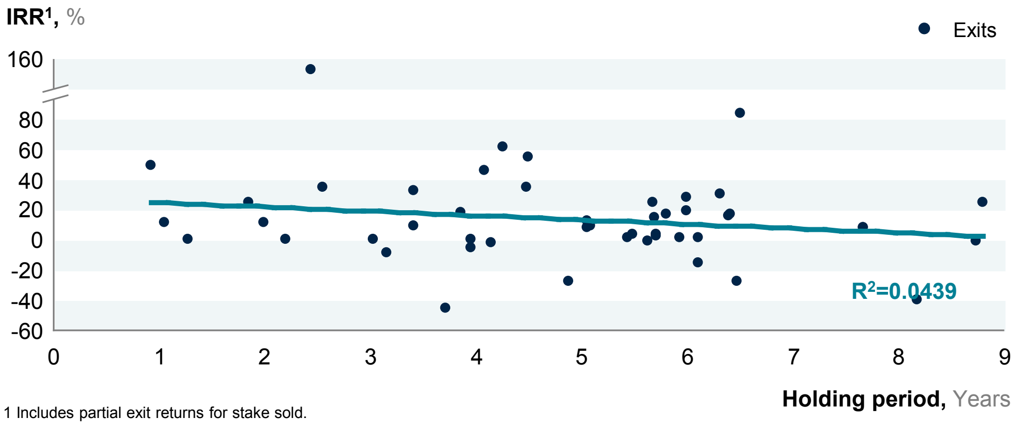
SOURCE: IIC members' survey; VCCEdge; McKinsey analysis

Myth 2: Patient capital is a necessary prerequisite

Our analysis shows holding periods at exit have been about five years in both average and median terms. This is shorter than the approximately ten years that a typical investor with "patient" capital would expect. Deals yielded a wide range of IRR no matter the holding period (Exhibit 13). Viewed another way, this also implies that social enterprises with strong business models do not need long holding periods to generate value for shareholders.

Exhibit 13

No clear relationship between returns and holding periods.



1 Includes partial exit returns for stake sold.

SOURCE: IIC members' survey; VCCEdge; McKinsey analysis

Myth 3: Investing for impact is for impact investors only

- Social investment calls for a wide set of investors if it aspires to maximise social welfare. Impact investors and conventional PE or VC funds play complementary roles. While both types of funds are active, impact investors usually back a greater number of smaller-sized deals relative to PE and VC funds. Complementary skills by different players are useful at different stages of evolution of investee companies:

  — Stage one needs early-stage investors with expertise in developing and establishing a viable business model, basic operations, and capital discipline.

  — Stage two calls for skills in balancing economic returns with social impact, and the stamina to commit to and measure the dual bottom line.

  — Stage three requires expertise in scaling up, refining processes, developing talent, and systematic expansion.

Impact investors are playing a big role in stimulating growth of social enterprises. Impact funds were the first investors in 62 percent of all deals (Exhibit 14), and in eight of the top ten microfinance institutions in India[21]. This led to traction from conventional PE and VC funds, even as business models of underlying industries matured.

Conventional PE and VC funds too played a material role as they brought larger pools of capital, which accounted for about 70 percent of initial institutional funding by value.[22] This is particularly important for capital-intensive and asset-heavy sectors such as clean-energy and microfinance. Overall, 48 percent of the capital in the industry was infused in deals by mainstream funds (Exhibit 15).

As club deals become more prevalent, they highlight the complementary role of both kinds of investor. Such deals are increasing: 32 percent of deals by value and 13 percent of deals by volume were done in partnership (Exhibit 15). As enterprises mature and impact investors remain involved, they are able to pull in funding from mainstream funds.

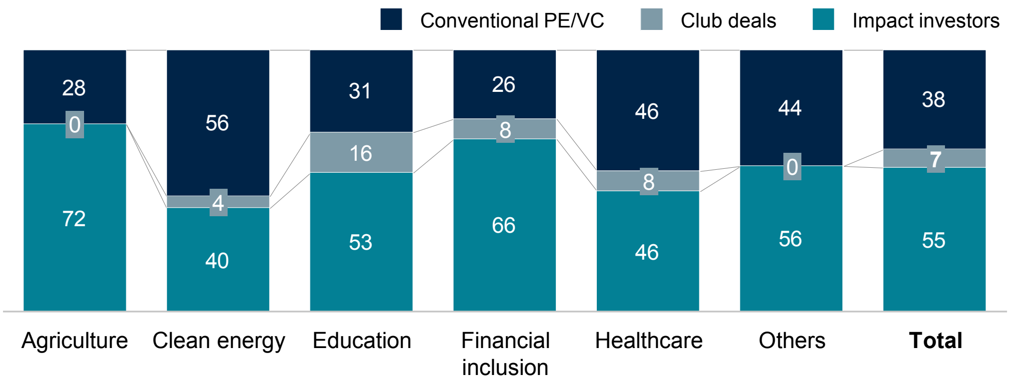
21 MFIN Micrometer 2016, press search.

22 VCCEdge, McKinsey analysis.

Exhibit 14

Impact investors play a critical role in seeding and de-risking social enterprises.

Role as "first institutional investor", % of deals as first institutional investor[1]



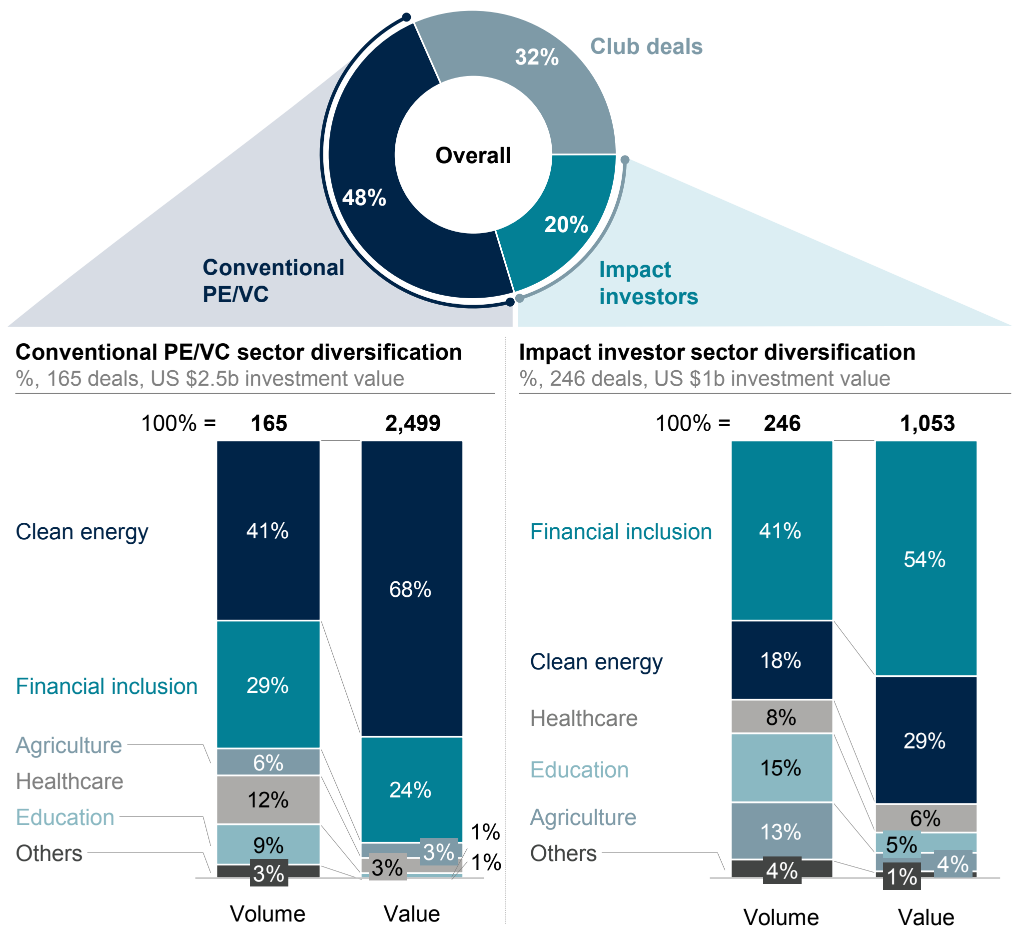
1 Based on data for 248 first institutional deals.

SOURCE: IIC members' survey; VCCEdge; McKinsey analysis

Exhibit 15

Sector diversity among different investors.

Value of impact investments by type of investor, 100% = US$ 5.2 billion cumulative investments



SOURCE: IIC members' survey; VCCEdge; McKinsey analysis

Equally important is the complimentary role non-profits organisations play in providing capacity with highly effective boots-on-the-ground capabilities. Non-profits have typically been on the ground for longer periods and have developed cost-effective mechanisms for delivery and implementation. Impact investors could be seen as strategic investors in non-profits who in-turn play roles in scale-up, talent attraction, and can deliver financial and operating leverage in return.

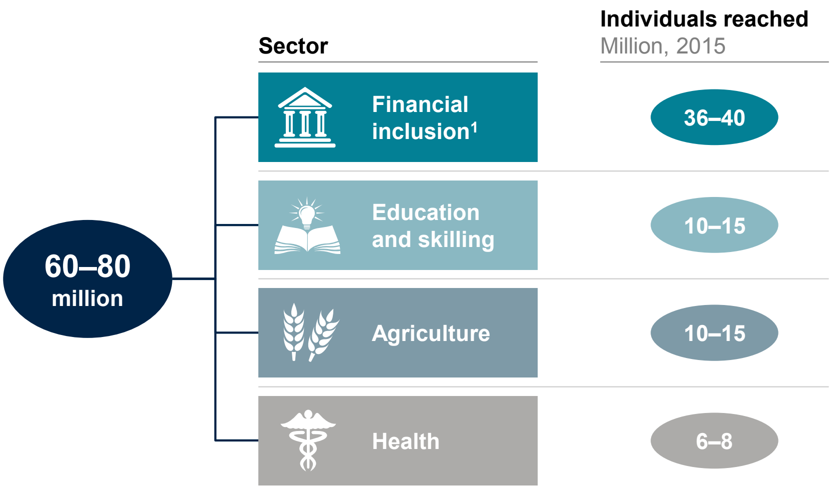
Erstwhile philanthropists have also started to recognise the impact potential of the industry. In the last 3 years, the Michael and Susan Dell Foundation has deployed 60–70 percent of their funds in India as impact investors.[23] With the intent to promote growth in varied sectors like financial inclusion, skill development, and urban education, MSDF acts as an LP, GP, and direct intervention agency as required to carry out its mandate.

Myth 4: Social enterprises backed by impact investors are small investments whose impact is a "drop in the ocean"

Impact investments generated a median gross IRR of 10 percent in dollar-adjusted terms as we saw in Exhibit 10. More significantly, they touched the lives of **60 million to 80 million** people in India (Exhibit 16). Equivalent to the entire population of France, their reach can no longer be called a drop in the ocean. Further, as these social enterprises scale, so will their impact.

Exhibit 16

Impact investor-backed institutions touch some 60 million to 80 million lives in India.



1 Does not include micro lending by public and private banks, non-MFI NBFCs, and Self-help groups (SHGs); additionally excludes clean energy as the sector has mostly indirect beneficiaries.

SOURCE: IIC members' survey; MFIN; ROC filings; VCCEdge; McKinsey analysis

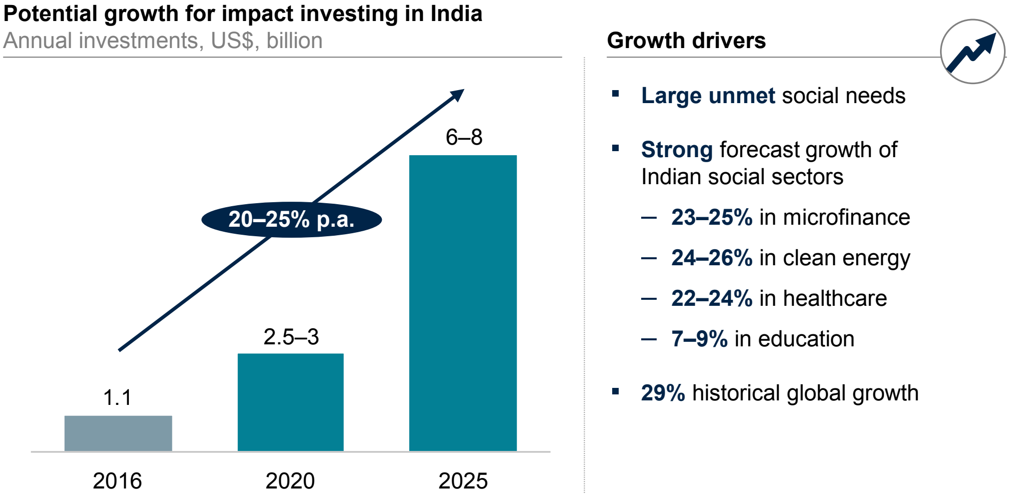
23 Interview with MSDF

Road ahead for impact investing in India: Complementing philanthropy

With a combination of high social needs with robust market forces, impact investors in India can make a strong case for growth. We believe impact investments have the potential to grow 20 to 25 percent a year between now and 2025, reaching US $6 billion to US $8 billion in deployment (Exhibit 17).

Exhibit 17

Impact investing in India has the potential to grow six to eight times by 2025.



SOURCE: IBEF, Press search; McKinsey analysis

Philanthropy has been the primary source for funding social investments for centuries. Yet, charitable giving is changing fast; the transfer of wealth to a younger generation that is far more engaged with social issues has contributed to these changes. Applying business and investment tools to social problems is becoming more popular.

While investors in the past looked mainly at risk and reward, they are gradually moving to a mind-set that considers risk, reward, and impact as equally important. The total value of philanthropic donations in India are about eight times higher than impact investments made in 2015.[24] It is clear that philanthropy and impact investments are twin engines playing a complementary and sometimes overlapping role to help solve social problems.

Along with social enterprises, India's non-profits continue to play a key role in the delivery of social services at scale. New and innovative service models have the potential to scale quickly by tapping into the strong grassroots network of non-profits.

Enterprises funded by impact investors touch **60 million to 80 million** lives today, and growing. Their reach is one measure of impact. Specific measures of social or environmental outcomes are critical to their success and important to their funders. We encourage greater transparency and rigour here.

24 *Strengthening philanthropic giving & impact investing for development in India,* Intellicap-McArthur, March 2016.

Strong secular growth and stable capital markets with the rule of law are two pillars that have attracted global investment to India since the country embarked on its path of liberalisation a quarter century ago. But even with these basics in place, the primary stakeholders, including government, regulators, and funds, will have to address several enablers to realise impact investment's potential.

Aiming for greater impact: What it will take

The impact investment industry and enabling ecosystem can take several steps to fulfil its potential in the next eight to ten years. We encourage industry participants to convene themselves and their partners around some of these topics to raise their importance and unlock required growth:

- **Pursue transparency measures.** The industry should identify clear and well-defined metrics for measurement. For example, it could standardise dual-performance metrics relevant to India at a sector level with local and global industry bodies. It could also collaborate with credible third parties such as credit rating agencies and chartered accountants to measure, audit, and report impact.

- **Expand funding.** Unlocking additional sources of strategic capital is essential. To do so, the industry could work with the Indian government to leverage corporate social responsibility (CSR) funds for approved uses in the impact-investing ecosystem. In addition, the industry could work with the government to create a "bottom of pyramid" fund of funds. Furthermore, the industry could create an outcomes fund backed by philanthropists, which will enable funding not just for social enterprises, but also to multiple partnering non-profits. Meanwhile another source of capital could be the global Indian diaspora. Other approaches include:

  — Educating and encouraging contributors to philanthropy to build conviction for impact investment and consider funding outcomes

  — Exploring retail investing participation—for example, mutual funds with an impact theme and social-sector unit trusts

  — Working with banks, regulators, and credit-rating agencies to bridge India's micro, small, and medium enterprise debt gap

  — Guiding social enterprises on ways to strengthen credit scores, including reporting compliance

  — Developing platforms such as social venture debt and crowdfunding

- **Market-backed innovations.** The industry could explore a wider set of market mechanisms for investing. It could broaden participation through instruments such as social or development impact bonds, with the support of specialised intermediaries. It could also incentivise dual goals through pay-for-performance schemes for investors and philanthropists, and in the long run, create new platforms such as a social stock exchange.

- **Governance and reporting.** The industry could develop higher and more transparent standards for diligence and reporting as well as apply standards of diligence, investment, and portfolio monitoring used in traditional investing.

- **Attract and develop talent.** The industry should harness the attractiveness of the social-environmental impact proposition to promote greater professional participation in funds and portfolio companies. The way forward might include introducing professional certification programmes with a social investment focus; supporting social sector CEOs with incubation, coaching, and board advisory services; and revisiting compensation and performance incentives to help bridge the gap with comparable alternative investment funds.

- **Strengthen industry collaboration.** Associations could work towards increasing awareness of the industry through forums and seminars, inviting regulators, social enterprises, CSR bodies, and conventional PE and VC investors. The industry could develop case studies for successful social enterprises beyond microfinance as well as explore more strategic coinvestment approaches to increase participation of other pools of capital that bring complementary skills.

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